FIVE YEAR
REVIEW COMMITTEE
DRAFT REPORT

~

REVIEWING THE
SECURITIES ACT
(ONTARIO)

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Letter from the Committee

May 29, 2002

We are pleased to release our Draft Report for public comment. This Draft Report is the culmination of more than two years of meetings, research and deliberations concerning the current state of securities legislation in Ontario. The Draft Report considers events and legislative reform as of March 2002. We invite you to read the Draft Report in its entirety, as it provides a thorough review of many areas of securities law, including those areas where we feel updating is necessary. A summary of the recommendations is contained in the Executive Summary. A glossary of terms used in the Draft Report is found at Appendix A.

Your attention may be particularly engaged by our discussions of the following topics:

1. **The need for a single, co-ordinated approach to securities regulation in Canada.** It is our very strong view that a nation that commands only two per cent of the global economy suffers daily from a regulatory regime which is comprised of 13 separate regulators. Please see our discussion at pages 21 - 28.

2. **The strengthening of the enforcement powers of the Commission.** We believe that enhanced powers to impose monetary penalties, and the introduction of anti-fraud and anti-market manipulation rules, will encourage enhanced compliance with Ontario securities laws. In addition, we believe the court should be able to impose increased prison terms where a breach has been proven pursuant to the quasi-criminal provisions in the Act. Please see pages 117 - 148.

3. **How to regulate in an increasingly technological world.** The Internet has greatly facilitated communications among people; the challenge for regulators is to determine what public policy considerations are engaged by increasingly sophisticated technologies, and the appropriate regulatory responses. Our discussion of these matters is found at pages 53 - 57.

4. **The need to introduce civil liability for secondary market disclosure by issuers.** We believe that securities legislation in Ontario and the other provinces should be amended quickly to provide for such liability. See pages 75 - 76.

5. **The introduction of a system of governance for mutual funds.** Please see our analysis and recommendations at pages 109 - 116.

Certain of our recommendations relate to issues on which the Commission and/or the CSA are already engaged, and our recommendations may be considered by the regulators in their current deliberations on these matters. Others are of a more urgent nature and we urge the regulators to consider them on a more immediate basis. We are also aware of other current initiatives, including the De-Regulation Project being undertaken by the British Columbia Securities Commission, and the CSA's Uniform Securities Law Committee. We suggest that our recommendations be considered in conjunction with these initiatives.

As the Draft Report was being finalized, Enron Corp., one of the world's largest energy, commodities and services companies, collapsed. The circumstances of this event are now being considered by regulators and legislators in the United States and Canada, with a particular focus on the reliability of corporate disclosure and the financial reporting process, corporate governance, and auditor independence. What conclusions will emerge from the Enron investigation are unclear. It is clear, however, that Enron has changed the way we look at the integrity of our capital markets. We encourage the ongoing debate and urge Canadian regulators and the industry to closely monitor the reforms emanating from the United States and ensure that Canada keeps pace with international standards.

Our report is being issued in draft form in order to solicit the views of the public on the issues we considered and our recommendations. The Draft Report is available on the website of the OSC at www.osc.gov.on.ca. We invite you to read it, consider its recommendations, and then share with us your thoughts on all of the Draft Report or on those parts which are of particular interest to you. The comment period will run until August 15, 2002. At the conclusion of the comment period we will reconvene as a Committee to consider carefully the comments we receive. We will then finalize the Draft Report and submit it to the Minister of Finance. The final report will also be published.

Please address your comments to:

Five Year Review Committee
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We ask that submissions to the Committee indicate a contact person and contact details (return address, telephone and fax numbers, e-mail address) of individuals who would be available to respond to inquiries from the Committee in connection with the submission.

Unless confidentiality is requested, we will place submissions on the Commission website and they will form part of the public record. Since we seek to discharge our mandate in an open and transparent manner, we discourage requests for confidentiality. We would like to draw your attention to the possibility that the press and members of the public may be able to obtain access to any comment letter, even if the Committee does not put the letter on the public file.

Sincerely,

Five Year Review Committee

Purdy Crawford, Chair	Carol Hansell
William Riedl	Helen Sinclair
David Wilson	Susan Wolburgh Jenah

Executive Summary

Introduction

Several themes emerged in the course of our deliberations. These themes, described below, are reflected in this Draft Report and our recommendations.

1. Regulation should support clearly identified public policy objectives and be proportionate to the objective. The benefits of regulation (and changes to regulation) must outweigh the costs imposed by it.

2. Canada competes with other jurisdictions around the world for capital and for investment opportunities. Our regulatory regime must be part of our competitive advantage. This requires that our regulators be able to operate efficiently and that our regulatory requirements not be more onerous than those existing in other jurisdictions (particularly the United States), except as may be required to satisfy our public policy objectives. It also requires that the markets have confidence in the enforcement powers of our regulators and that our regulators have the resources necessary to exercise those powers.

3. Increased harmonization of securities regulation nationally and internationally is imperative to ensure that Canadian capital markets are competitive with other jurisdictions.

4. Securities regulation must be flexible enough to allow regulators to react to changing circumstances on a timely basis.

The recommendations resulting from our deliberations are set out below, along with a reference to the page of the Draft Report on which the particular recommendation can be found. You will find it helpful also to consider the reasons for each recommendation, which are set out in the part of the Draft Report accompanying the recommendation.

Recommendations

Part 1: The Role of the Commission in Capital Markets Regulation	**Page**
1. We recommend that the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada.	28
2. In the meantime, we recommend that certain steps be undertaken by securities regulators to continue to harmonize securities regulation across Canada. Harmonizing provincial securities legislation would significantly simplify securities regulation in Canada. We also recommend that securities regulators be given the authority to delegate any power, duty, function or responsibility conferred on them to another securities regulatory authority within Canada, and that they actively engage in delegation among themselves. We recommend the Act be amended to give the Commission this authority, and that the necessary consequential amendments to the immunity provisions in the Act be made. In addition, we recommend that securities legislation across the country be amended to provide for "mutual recognition" – that a securities regulator may deem that compliance by a market participant with securities laws in another specified Canadian jurisdiction constitutes compliance with securities laws in the regulator's own jurisdiction.	28

3. We recommend that the Commission and the CSA permit both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP. Issuers who prepare their financial statements in accordance with U.S. GAAP should be required to reconcile the statements to Canadian GAAP during a transitional period. The duration of the transitional period should be determined by the regulators taking into account whether significant comparability issues will arise if no reconciliation is provided. **32**

4. We encourage the move by both Canadian regulators and standard setters to International Accounting Standards and hope that Canada will continue to play a leadership role in this area. **32**

5. We encourage the Commission and the CSA to continue developing securities transfer legislation modelled on revised Article 8 of the *Uniform Commercial Code* in the United States and we urge governments across Canada to ensure that such legislation is adopted on a uniform basis. **33**

6. We encourage the Commission to continue its ongoing participation in IOSCO initiatives and urge the Commission to adopt, in a timely fashion, changes to its rules to implement the international standards emanating from IOSCO. **34**

7. We recommend that the CSA, provincial and territorial governments and the federal government move to adopt a system of harmonized functional regulation across Canada, whereby all Canadian capital market activities, products and conduct are regulated by a single market conduct regulator and fiscal solvency matters are regulated by a single prudential regulator. **38**

Part 2: Flexible Regulation

8. We recommend that section 2.1 of the Act be amended to direct the Commission to have regard to the following additional principles in pursuing the objectives of the Act: **41**

- Effective and responsive securities regulation should promote the participation of informed investors in the capital markets.
- Capital markets are international in character and it is desirable to maintain the competitive position of Ontario's capital markets.
- Innovation in Ontario's capital markets should be facilitated.
- The administration and enforcement of Ontario securities law should not unnecessarily impede or distort competition among persons carrying on regulated activities.

9. The Act should be amended to the extent necessary to ensure that the basic principles underlying our approach to securities legislation are contained in the Act. **43**

10. The Commission, together with the Ontario government, should seek to streamline the Act by incorporating detailed requirements in the rules. In addition, the Committee believes that the Act should accurately reflect current law. This may result in certain exemptions being removed from the Act altogether where they have been superseded by a rule. **43**

11. We recommend that the Commission be given "basket" rulemaking authority that is substantially identical to that conferred on the Lieutenant Governor in Council pursuant to clause 143(2)(b) of the Act. The Commission should be given the authority to make rules respecting any matter that, in the opinion of the Commission, is "necessary or advisable for carrying out the purposes of the Act." **46**

12. We recommend that the minimum initial comment period for rules be reduced from 90 to 60 days and that the minimum initial comment period for policies be reduced from 60 to 30 days. **47**

13. We recommend that the Act be amended to require that the Commission republish for comment a proposed rule only if the Commission proposes changes to a rule that the Commission considers to be material, having regard to: **48**

(a) the nature of the changes proposed to the rule as a whole; and
(b) whether the final rule is a logical outgrowth of the rulemaking process when viewed in light of the original rule proposal and request for comments.

We further recommend that a similar test be adopted for the republication of policy statements.

14. We recommend that the period for Ministerial approval of rules be shortened from 60 to 30 days. **48**

15. We urge the Commission to limit the number of projects that it takes on and focus its resources on fewer critical policy issues. We further recommend that the Commission streamline its internal rulemaking process by, among other things, focussing on fewer policy projects and establishing internal standards for the development of rule and policy proposals, including benchmark timeframes for reviewing and responding to comments on a rule or policy proposal. **48**

16. The Commission should undertake, as appropriate, cost-benefit analyses to assess the effectiveness of proposed regulations. The Commission should make public these cost-benefit analyses. If no analyses are completed, the Commission should specifically explain why they were not. **49**

17. We recommend that the legislation be amended to allow the Commission to issue blanket rulings and orders that provide exemptive relief only. We further recommend that blanket rulings and orders be used only as an interim measure. Therefore, they should be subject to a sunset period under which any blanket ruling or order issued by the Commission will automatically expire in three years unless converted sooner into a rule. **51**

18. We recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also urge the Commission to consider whether there should be some notice when exemptive relief applications are not granted, and of the reason for the refusal. **51**

19. We recommend that the Act be amended to require that future review committees be appointed five years after the date of delivery of the final report of the previous committee, in contrast to the current requirement which prescribes that committees be appointed every five years. **52**

20. The Committee recommends that the CSA consider whether NP 11-201 and NP 47-201 conflict with provincial legislation such as the ECA. The Committee believes the CSA should ensure that the guidance provided by it continues to be operative. **54**

21. In light of investor protection concerns, the Committee is of the view that it would not be prudent to eliminate the need for registrant involvement in Internet offerings. **56**

22. The CSA should begin to consider alternative models for delivery of documents, whether the implementation of an alternative delivery model is feasible, the substantive rules that would underpin an alternative delivery model and how the model could be implemented. **57**

23. In considering the implementation of an alternative model for delivery of documents, the CSA should consider distinguishing between disclosure documents that contain corporate information but do not require any immediate action by a shareholder (such as financial statements) and disclosure documents that require shareholders to take some form of specific action in connection with a particular corporate transaction (such as a take-over bid circular). Such an alternative communication model might introduce the "access-equals-delivery" approach only with respect to documents that do not require the shareholder to take any specific action. **57**

Part 3: Regulation of Market Participants

24. We recommend that the registration requirement relating to trading should be moved to a model requiring the person or company to be "in the business" of trading. However, we would only support such a change if it were to be adopted across the country. **60**

25. The current requirements in the Act to be registered either as an adviser or to trade in a security should be retained. However, the Commission and CSA should carefully review the proficiency, experience and suitability requirements applicable to dealers and employees to ensure that they are sufficiently rigorous to match the increasingly important role of "ancillary advice" delivered by dealers and their employees. **61**

26. The Committee encourages the Commission, together with the CSA, to continue to monitor the use of financial portals by market participants, and to facilitate their development where appropriate. Where portals conduct activity in violation of the requirements of the Act, we believe the regulators should bring enforcement proceedings. **63**

27. We recommend the Act be amended to eliminate the universal registration requirements. **64**

28. The Act should be amended to require that SROs, as defined by the Act, must be recognized to carry on this function in Ontario. **66**

29. We recommend that clearing agencies should be required to obtain recognition. We recommend amending section 21.2 of the Act to provide that "No person or company shall carry on business as a clearing agency unless recognized by the Commission." **66**

30. We recommend that the Commission and the CSA consider whether to require QATRS and the unlisted market to obtain recognition under securities legislation and to develop a harmonized approach to QATRS and the unlisted market. **67**

31. We recommend that SROs be required to report to the Commission any breaches or possible breaches of securities law that they believe have occurred or may have occurred. **68**

32. The Committee recognizes that there is considerable potential for conflict between an SRO's role as a trade association and its responsibilities as an SRO. Ideally, we believe that trade association and SRO functions should be carried out by two separate bodies, each with distinct governance structures. In this regard, the body charged with the SRO role should ensure that at least 50 per cent of its directors are independent from its members. We support the model adopted by the Securities Industry Association and the NASD in the United States. **69**

Part 4: The Closed System and Secondary Markets

33. The Committee recommends that the Act be amended to explicitly refer to continuous disclosure reviews. **74**

34. We encourage the CSA to harmonize Canadian continuous disclosure requirements and to create a base or minimum level of continuous disclosure requirements applicable to all reporting issuers. **74**

35. We support the CSA proposal to create a statutory civil liability regime for continuous disclosure and urge the Government of Ontario to move forward as soon as possible to adopt such a regime by legislative amendment. We also encourage the governments of the other CSA jurisdictions to adopt the regime. **76**

36. The closed system is overly inclusive, inefficient and complex. Most importantly, the system cries out for simplification and greater convergence of requirements across the country. We encourage the CSA to proceed with further reforms to the prospectus exemptions and the closed system with convergence of requirements and simplification as twin goals. **78**

37. Once other reforms are implemented, such as civil liability for continuous disclosure, enhanced continuous disclosure standards for all reporting issuers, more independent due diligence in connection with continuous disclosure and a more integrated disclosure system overall, we believe hold periods for securities of reporting issuers could be eliminated without sacrificing investor protection while contributing significantly to more efficient capital markets. **80**

38. As we have noted in connection with hold periods, if the reforms we contemplate in this Report are implemented, we believe the need for seasoning periods in the case of reporting issuers should also be revisited with a view to their elimination. **81**

39. The closed system should continue to apply to non-reporting issuers. **81**

40. The Commission should examine the practice whereby control block holders reduce applicable hold periods through the use of derivatives and other monetization structures. We recommend that the Commission issue guidance on this practice and, if necessary, utilize its public interest jurisdiction under section 127 of the Act to address it. **81**

41. We believe that, as other reforms to secondary market regulation are implemented, there may be no need for hold periods and other resale restrictions. We encourage a public debate as to whether hold periods and seasoning periods – hallmarks of the existing "closed system" – continue to serve a public policy purpose or whether they are an idea whose time has come – and gone. **82**

42. We recommend that the Act's timely disclosure provisions not be amended to require disclosure of "material information." **86**

43. We recommend that the existing materiality standard should be changed for all purposes under securities legislation to a "reasonable investor" standard. **88**

44. While the Committee does not believe that legislative change is required in Ontario to address the issue of selective disclosure, we support the CSA's policy statement and an increased emphasis on enforcement in this area. **91**

45. We recommend that the periods for filing annual financial statements be reduced to 90 days after the fiscal year end and that the time periods for filing interim financial statements be reduced to 45 days after the end of each quarter. **92**

46. Ontario securities legislation should be amended to require that quarterly financial statements must be reviewed by the issuer's external auditor. **93**

47. Ontario securities legislation should be amended to require that press releases containing financial information or earnings information must be filed on SEDAR. **94**

48. We recommend that the GAAP exemption available to banks and insurance companies in subsection 2(3) of the Regulation to the Act be removed. Alternatively, we believe that the GAAP exemption should be limited to permit OSFI to override GAAP only where there is demonstrable prudential concern in order to contain or prevent solvency risk. The recent amendments to the GAAP override relating to bank holding companies should also be reconsidered. **96**

49. We recommend that the Commission be given rulemaking authority to prescribe requirements relating to the functioning and responsibilities of audit committees of reporting issuers. We encourage other CSA jurisdictions to give their commissions similar powers, and we urge the CSA to work together expeditiously to establish standards for audit committees that will make Canadian audit committees "best in class" internationally. **97**

50. We urge the Commission to pro-actively monitor ongoing U.S. developments relating to auditor independence and to consider what reforms are necessary to ensure that Canada does not lag behind international standards. **99**

51. We recommend that the Commission adopt amendments to proxy disclosure rules to require public companies to disclose in their proxy statements their expenditures for both audit and non-audit consulting services. **99**

Part 5: Enhancing Fundamental Shareholder Rights

52. We support the reforms to the CBCA relating to proxy solicitation. We believe that Part XIX of the Act should be similarly amended to ensure that shareholders are able to communicate with each other in prescribed circumstances without having to file an information circular. We believe that the Commission should co-ordinate with the provincial government so as to ensure that amendments adopted under the OBCA and the Act are uniform. We further recommend that the Commission consider whether it has the authority to incorporate by reference the requirements of another Canadian statute such as the OBCA or CBCA with regard to proxy solicitation, rather than stating the rules explicitly in the Act. **103**

53. We recommend that the Commission, together with the CSA, undertake further study to determine whether amendments to securities law are necessary with regard to communications with and among shareholders in the context of a take-over bid. **104**

54. Nothing has come to our attention that would support the need to regulate arrangements and take-over bids in an identical fashion. We believe that, as a matter of public policy, parties to commercial trans- **105**

actions should have the freedom to structure transactions to achieve their business purposes so long as these transactions, and the legislation that governs these transactions, are fair to all interested parties. The Committee notes that it is especially important to harmonize take-over bid regulation across the country and encourages the CSA to adopt a harmonized approach to these issues.

55. The Commission should consider preparing a policy statement setting out guidance as to when in a take-over bid a poison pill must be terminated. **108**

56. The Commission and the CSA should introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body. This body should have the right to terminate the mutual fund manager when, in the reasonable opinion of the independent directors, there is cause, including poor performance of the fund, or where the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or breach of its fiduciary obligations. **113**

57. We recommend that the process by which potential directors of mutual fund governance bodies are identified and nominated be expanded so as to include a broader range of potential directors. We further recommend that the majority of directors be independent of the management company. **114**

58. The mutual fund governance body should have certain characteristics including: independence from the manager; a majority of independent directors; the right to retain counsel and other independent advisers; and the right to set its compensation and establish the obligation of each member to disclose annually all fees received from the fund and all affiliated funds. **114**

59. We believe that it is important to identify certain fundamental responsibilities of the mutual fund governance body. We believe these responsibilities should include, at a minimum: overseeing the establishment and implementation of policies related to conflict of interest issues; monitoring fund performance, fees, expenses and their allocation; ensuring compliance with investment goals and strategies; reviewing the appointment of the auditor; and approving changes to investment goals and strategies and approval of material contracts. **115**

60. Mutual fund managers should be subject to independent oversight of their capital adequacy, personnel proficiency and standards of business practice. We believe that this oversight can be conducted by the independent governance body. **116**

61. Subsection 143(31) of the Act should be amended, as required, to give the Commission the necessary authority to address mutual fund governance reform through its rulemaking power. **116**

Part 6: Enforcement

62. We recommend that section 127 of the Act be amended to add new paragraphs authorizing the Commission, if in its opinion it is in the public interest, and if it determines that a person or company has contravened Ontario securities law, to make an order: **126**

- requiring the person or company to pay an administrative fine of up to $1,000,000 per contravention of Ontario securities law;
- requiring a person or company to disgorge profits made as a result of its contravention of Ontario securities law.

63. In addition, we recommend that subsection 3.4(2) of the Act be amended to read as follows: **127**
"The Commission shall pay into the Consolidated Revenue Fund money received by it as a payment to settle enforcement proceedings commenced by the Commission, ***or pursuant to an order made by the Commission pursuant to section 127,*** but not money received by the Commission,

- to reimburse it for costs incurred or to be incurred by it; or
- that is designated under the terms of the settlement ***or identified in a Commission decision*** as money to be used for allocation to or for the benefit of third parties ***in furtherance of the purposes of the Act.***"

64. We recommend that a new offence be created under section 122 of the Act, for failing to fulfill, or contravening, a written undertaking to the Commission or the Executive Director. **127**

65. We recommend that the Commission monitor the FSA's exercise of its new restitution power and consider the experience in the United Kingdom, with a view to revisiting in the future whether a power to order restitution would be an appropriate remedy for the Commission. **128**

66. We encourage the Commission to consider exercising its discretion, in appropriate cases, to apply to the court under section 128 of the Act for a restitution or compensation order. **128**

67. We encourage the establishment of a national complaint-handling system in which participation by financial services providers is mandatory. The system should be independent of government and industry, provide information and general guidance on the complaint-handling process, and have a centralized process for handling calls and compiling and reporting statistics. The system should also include an Ombudsman who would have the authority to make decisions that are binding on the financial services provider but not the investor. The investor's right to further pursue the complaint through other available avenues, such as arbitration or litigation, would be unaffected. **131**

68. We also recommend that, as a condition of its recognition of an SRO, the Commission should require the SRO to require its members to participate in and agree to be bound by any national complaint-handling system that is in place, as well as any industry-sponsored dispute resolution program that may be applicable. We favour transparency in connection with such programs and strongly encourage the publication of statistics on the use of the programs as well as details concerning the outcomes of cases or the resolution of complaints. **132**

69. We strongly encourage the IDA and any other SROs that have or may be contemplating alternative dispute resolution programs to, at a minimum, require their members to advise customers of the availability of such programs and publish statistics relating to the program. **132**

70. We encourage further work by the financial services industry toward the goal of creating a national dispute resolution system and ultimately consolidating the complaint-handling and dispute resolution systems into one seamless process. **132**

71. We recommend that paragraph 127(1)7 of the Act be amended to authorize the Commission to order that a person resign one or more positions that the person holds as a director or officer of an issuer, ***registrant or manager of a mutual fund.*** **135**

72. We recommend that paragraph 127(1)8 of the Act be amended to authorize the Commission to order that: **135**

- a person be prohibited from becoming or acting as a director or officer of any issuer, *registrant or manager of a mutual fund;*
- *a person or company be prohibited from becoming or acting as a manager of a mutual fund or as a promoter;* and
- *a person or company be prohibited from engaging in touting of securities or promotional activities relating to the purchase or sale of an issuer's securities.*

73. We also recommend that the Act be amended to include a definition of touting of securities or promotional activities, similar to the definition of "investor relations activities" in the British Columbia Act. **135**

74. We recommend that a new paragraph be created under subsection 127(1) of the Act, authorizing the Commission to order that a person or company: **136**

- comply with or cease contravening:
  - (i) Ontario securities law; or
  - (ii) a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.
- take steps to ensure future compliance with Ontario securities law, or a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.

75. We recommend that paragraph 127(1)2 of the Act be amended to expressly provide that "trading" in securities for purposes of that paragraph includes the purchase of securities. **137**

76. We recommend that subsection 122(1) of the Act be amended to increase the maximum fine to $5,000,000 and to increase the maximum term of imprisonment to five years less one day. **140**

77. We recommend that subsection 122(4) of the Act be amended to increase the maximum fine under that provision to "not more than the greater of (a) *$5,000,000;* and (b) an amount equal to triple the profit made or loss avoided by the person or company by reason of the contravention." **140**

78. We recommend that section 122 of the Act be amended to include a provision permitting the Ontario Court of Justice to make an order, where appropriate, that the defendant compensate or make restitution to persons who have suffered a loss of property as a result of the commission of an offence by the defendant. **141**

79. We recommend that the Commission issue a policy statement providing interpretative guidance on the scope of the confidentiality provision in section 16 of the Act and the process for making an application for disclosure under section 17 of the Act. **143**

80. We recommend that the Act be amended to expressly prohibit market manipulation and fraudulent activity. **145**

81. We recommend that the Act be amended to include a provision prohibiting a person or company from making a statement, written or oral, that the person or company knows or ought reasonably to know is a misrepresentation. We also recommend that consideration be given to whether it is appropriate to limit the prohibition to statements made "with the intent of effecting a trade" in a security. **145**

82. We suggest that, in appropriate cases, the Commission consider pursuing alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.	**147**
83. We recommend that the CSA consider as part of its proposed Civil Liability Amendments whether it would be desirable to broaden existing insider trading civil liability provisions.	**147**
84. We recommend that the CSA consider further reducing the period for filing insider reports (from the current requirement to file within 10 days of the date of the trade) once SEDI is fully operational.	**148**
85. We recommend that Ontario securities law be amended to require insiders to report any effective change in, or disposition of, their economic interest in an issuer.	**148**

Introduction

1. Evolution of the *Securities Act*

The first securities law statute in Ontario *(The Security Frauds Prevention Act 1928)*[1] dealt with little more than the licensing of stock brokers and investigations into securities frauds. In 1945, securities regulation in Ontario was significantly expanded with the enactment of *The Securities Act, 1945*,[2] which introduced the concept of distributions of securities to the public and required issuers to make certain limited disclosure. *The Securities Act, 1947*[3] imposed additional disclosure and other requirements for public distributions of securities and introduced statutory civil liability for false statements made in a prospectus.

Our current Act originated with *The Securities Act, 1966*,[4] which introduced or modified provisions dealing with continuous disclosure, proxy solicitation, take-over bids and insider trading. These amendments were based largely on the recommendations of the *Report of the Attorney General's Committee on Securities Legislation in Ontario* (informally known as the "Kimber Report"). The closed system was introduced in *The Securities Act, 1978*[5] and in 1983 the take-over bid provisions of the Act were significantly revised as a result of the recommendations of the report of the "Three Wise Men."[6]

The most recent significant amendments to the Act were made in 1994, following the release of a report of a joint Ministry of Finance and Ontario Securities Commission Task Force on Securities Regulation, chaired by University of Toronto law professor Ron Daniels.[7] The Daniels Committee was established in October 1993 following an Ontario court decision[8] declaring a Commission policy statement on the sale of penny stocks invalid on the basis that the Commission had "exceeded its jurisdiction under its enabling legislation in promulgating it." As part of the 1994 Amendments, the Commission was given the authority to make rules with binding legislative effect, subject to a process involving both public comment and review of the proposed rule by the Minister of Finance.

As a consequence of the enactment of the 1994 Amendments, the Commission undertook to review all of its existing policy statements, notices, blanket orders and rulings, and to reformulate them as rules, policies or staff notices or decide they were no longer appropriate or necessary. This process is commonly referred to as the "Reformulation Project."

2. Establishment of the Committee

The 1994 Amendments imposed a requirement that the Minister of Finance (the "Minister") establish an advisory committee every five years to review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission.[9] This is the first such committee to be established.

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[1] S.O. 1928, c. 34

[2] S.O. 1945, c. 22.

[3] S.O. 1947, c. 98.

[4] S.O. 1966, c. 142.

[5] S.O. 1978, c. 47. The closed system was drawn from recommendations of the *Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements* (Toronto: Department of Financial and Commercial Affairs, 1970) [hereinafter the "Merger Report"].

[6] Gordon Coleman, Garfield Emerson and David Jackson, *Report of the Committee to Review Provisions of the Securities Act (Ontario) relating to Take-over Bids and Issuer Bids* (Toronto: Ontario Securities Commission, 1983).

[7] See Task Force on Securities Regulation, *Responsibility and Responsiveness – Final Report of the Ontario Task Force on Securities* Regulation (1994), 17 OSCB 3208 [hereinafter the "Daniels Report"].

[8] *Ainsley Financial Corporation* v. *Ontario Securities Commission* (1993), 14 O.R. (3d) 280 (General Division).

The Act requires the Committee to:

- review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission;
- solicit the views of the public in respect of these matters by means of a notice and comment process; and
- prepare for the Minister a report of its review and recommendations.

In addition to this legislated aspect of our mandate, the Minister directed us to ensure that:

- securities legislation in Ontario is up to date; and
- securities legislation in Ontario enables the Commission to proactively enforce clear standards to protect investors and foster a fair and efficient marketplace.

3. Methodology

(a) Request for Comments on Issues List

Because our mandate was very broad, our first challenge was to adopt a methodology to guide us. We began by developing an Issues List as a means of soliciting the views of the public. This was prepared with the benefit of input from the Commission. The Issues List was published in the Bulletin on April 28, 2000[10] and is attached as Appendix B.

The Issues List addressed 42 issues under five broad headings:

(i) Principles Underlying Securities Regulation;
(ii) Focus and Scope of Legislation;
(iii) Impact of Regulatory Harmonization and Globalization Trends;
(iv) Impact of Technology; and
(v) Mandate and Role of the Commission.

The Issues List was not intended to be exhaustive or to limit in any way the issues which the Committee was prepared to consider. It was intended to focus the Committee on those areas in which the need for legislative change was viewed as being most pressing and to act as a catalyst for public comment. Our Draft Report does not address all of the issues on this list. In many cases, no information or concerns came to the attention of the Committee to cause us to believe that any amendment to the Act was necessary. On the other hand, this Draft Report does deal with a number of issues that were not included on our Issues List, but instead were raised with the Committee by commenters. Lastly, our Draft Report may, in some cases, address issues that were included on the Issues List even though we are not recommending any legislative change in these areas. We do so where we believe the issue is significant enough to merit drawing attention to our analysis and preliminary conclusions so that others, who may agree or disagree with us, have an opportunity to do so. We will consider comments received on these matters before finalizing the report.

(b) Research

The Committee's staff prepared memoranda analyzing each of the 42 issues on the Issues List. Additional research was done in response to issues raised by commenters and by the Committee in the course of its deliberations. Much of the work done by the staff was original research. The staff also drew on existing research and analysis by Commission staff and by the staff of other commissions for the CSA. In addition, Commission staff made presentations to the Committee on various issues under consideration by the Committee.

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[9] The Act, s. 143.12.

[10] See (2000), 23 OSCB 3034 or http://www.osc.gov.on.ca/en/Summary/fiveyearreview.html.

(c) Comparative Analyses

The research conducted for the Committee went beyond an analysis of Ontario securities laws. The Committee considered the approach used by securities regulators in other Canadian jurisdictions. It also looked for guidance to the regulatory regimes in the United States, the United Kingdom and Australia. Each of these jurisdictions has introduced reforms to various aspects of capital markets regulation in recent years and accordingly the Committee had the benefit of some very thoughtful analysis of securities regulators from across Canada and around the world.

(d) Written Submissions and Presentations

The Committee received 31 written submissions in response to our request for comment on the Issues List.[11] Certain organizations and individuals met with us at our request.[12] In addition, Commission staff made presentations on topics of particular interest to the Committee.[13]

(e) Meetings of the Committee

The Committee met approximately 50 times over a period of 20 months prior to the release of the Draft Report.

4. Next Steps

(a) Finalizing the Report

Once the period for commenting on this Draft Report is concluded, we will reconvene as a Committee to consider the comments we receive. We will then finalize the report.

(b) Submission of the Report to the Minister

The Committee will submit its final report to the Minister. The Act requires that the report be tabled with the Legislature and that a select or standing committee of the Legislative Assembly then be appointed to:

- review the report;
- hear the opinions of interested persons or companies; and
- make recommendations to the Legislative Assembly regarding amendments to the Act.

(c) Future Committees

The Minister will appoint the next Five Year Review Committee in 2004. We anticipate that, since our Draft Report constituted such a broad survey of securities legislation, subsequent Five Year Review Committees will be able to focus their mandate more narrowly. We suggest that the Act be amended to require that future committees be appointed five years after the date of delivery of the final report of the previous committee, in contrast to the current rule which requires committees to be appointed every five years.

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[11] A list of those individuals or groups who made written submissions to the Committee is attached as Appendix C to this Draft Report. The submissions can be found online at http://www.osc.gov.on.ca/en/Summer/commentletters.html.

[12] A list of individuals and organizations that met with the Committee at the Committee's request is attached as Appendix D to the Draft Report.

[13] A list of Commission staff who made submissions to the Committee is attached as Appendix E to this Draft Report.

PART 1
THE ROLE OF THE COMMISSION IN CAPITAL MARKETS REGULATION

The activities of participants in Canada's capital markets may be subject to the jurisdiction of securities regulators in up to 13 jurisdictions in Canada and of securities regulators in other parts of the world. Certain activities may also come within the jurisdiction of federal financial institution regulators. Part I of our report discusses how capital markets regulation in Ontario – and across Canada – should be rationalized to increase efficiency without sacrificing investor protection.

Chapter 1: The Need for a Single Regulator

We add our voice to countless others raised in support of the urgent need for a single Canadian securities regulator. This is the most pressing securities regulation issue in Ontario and across Canada. We urge the Minister to assume a leadership role in working with her colleagues across the country to resolve any remaining barriers to the establishment of a single regulator responsible for Canada's capital markets activity.

1.1 Capital Market Formation Transcends Borders

(a) Ontario's Place in the Canadian Capital Markets

Transactions between an issuer and investor who are both resident in Ontario are subject to Ontario securities regulation. However, issuers often do not confine their search for prospective investors to those resident within the issuer's own province or territory and must therefore comply with securities regulatory regimes in more than one jurisdiction. This necessarily increases costs. An issuer must retain the services of registrants and counsel, and pay fees in each jurisdiction in which it proposes to issue securities. It must then hire employees or outside advisers to ensure that it complies with its continuous disclosure obligations in each jurisdiction. From a regulatory perspective, each jurisdiction must maintain the resources necessary to administer and enforce its securities law.[14]

Issuers and investors alike are affected when the costs of compliance in Canada are higher than they are elsewhere. Increased compliance costs affect our competitive position as a source of capital. This, in turn, affects investment opportunities available to Canadians. Issuers who are in a position to do so may look outside of Canada for lower cost of capital. Those who are not in a position to look elsewhere must accept a higher cost of capital and the implications this has for their performance and ability to compete. In order for Ontario capital markets to remain competitive, they must operate as an integral part of the broader Canadian capital markets.

Canada's stock exchanges have already reacted to the

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[14] The FSA estimates that the total cost of Canadian regulation, including prudential regulation and market regulation of securities, insurance, listing and clearing to be about 218 million pounds ($493 million, at current exchange rates) versus the FSA's own regulatory cost of about 220 million pounds ($497 million) and in Australia at 104 million pounds ($235 million). Approximately 3,780 people are employed in Canada to regulate the financial services sector versus 2,765 in the United Kingdom and 2,113 in Australia. See FSA Annual Report 2000/01 Appendix 5: Comparison of Costs of Regulation in Different Jurisdictions (http:www.fsa.gov.uk/pubs/annual).

inefficiencies inherent in regionalization. In order to remain competitive, they have consolidated and restructured,[15] with the result that each of the three remaining exchanges – the TSX, TSX Venture and the Bourse de Montréal – now deals exclusively with one segment of the market. Senior issuers list on the TSX, junior issuers list on TSX Venture and derivatives trade on the Bourse de Montréal.[16]

(b) Canada's Place in Global Capital Markets

Canada represents only two per cent of the world's capital markets.[17] There is literally a whole world of opportunity for both issuers and investors outside our borders. In Chapter 2, we discuss the merits of harmonizing Canadian securities laws with those of other major markets (primarily the United States) so that Canadian issuers are not faced with the costs of complying with radically different regimes at home and abroad. Here we note that the challenges of harmonizing our securities laws with those of major world markets are multiplied many times over by our current regime. Canada is the only G-7 industrial country that does not regulate its capital markets through a single regulator. Ensuring that Canadian capital markets remain globally competitive is among the most compelling reasons for consolidating Canadian securities regulation under a single regulator.

1.2 Thirteen Regulators for One Small Market

(a) Our Structure Today

Because securities regulation in Canada is a matter of provincial jurisdiction, there are 13 different sets of securities laws administered by 13 provincial and territorial regulatory authorities. Many of the statutes are similar to one another. Some have provisions that are entirely distinctive. None of them is identical. Even where the statutory provisions are identical, they may be interpreted and applied differently from one jurisdiction to the next.

There is also great variance in the status and function of securities regulators across the country. Some are self-funding agencies. Others are Crown corporations. Still others are agencies of their provincial governments. Some formulate policy, make rules, sit as administrative tribunals and hear appeals from decisions of their executive director or staff. Some perform only certain of these functions. Even where securities regulators perform like functions (such as rulemaking), they typically operate within statutory frameworks that are sufficiently distinctive to make co-ordination of efforts across jurisdictions a major challenge.[18]

The advantage of the current multiplicity of regimes is that it allows each legislature and securities regulator to develop and administer securities laws in a manner that best serves its local market. Economic activity differs from region to region across the country and securities laws controlled at the provincial level are best able to respond to specific regional needs. However, the price for this local flexibility is a balkanized approach to securities regulation that makes it more time consuming and expensive for issuers to raise capital across the country. Investors, market participants and their advisers are consistent in their criticism of this approach. In its submission to the Committee, TSX Venture articulated the frustration expressed by many others with the existence of 13 securities regulatory regimes:

> The complexity in the current regulatory regime is considerably exacerbated by the differences in regulation

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[15] Prior to this restructuring, the Vancouver Stock Exchange, Alberta Stock Exchange, Winnipeg Stock Exchange, TSX, Montreal Exchange and CDN operated independently of one another and, to a large extent, competed with one another for listings.

[16] The TSX recently completed its acquisition of TSX Venture.

[17] This figure is often used and, while it may have various meanings, in this context we refer to the weight given to Canadian equities in the MSCI World Index. The MSCI World Index is based on the market value of 86 selected equities based on MSCI criteria.

[18] See discussion on Rulemaking in Chapter 6.

> between provinces. Slight variations in the regulation between provinces may at first seem to be relatively insignificant but these slight differences act as a trap for issuers, their insiders and advisers. In order for an issuer or its insiders to avoid these pitfalls, they must incur additional legal and advisory costs.
>
> We strongly encourage the Ontario government, and each of the other provincial governments to provide a strong incentive to their respective provincial securities commissions to work together to create a standardized set of securities rules which can be adopted in each province. Although there may occasionally be the need for certain local initiatives, we submit that such differences should be the exception. ...We note that local differences have often been justified on the basis of accommodating small business; however, we believe that challenges in this area are not regional and a more consistent approach nationally will improve the access to capital. [19]

(b) Failed Attempts to Consolidate

Over the last four decades, there have been several unsuccessful attempts to create a single securities regulatory authority in Canada. In 1964, the Royal Commission on Banking and Finance (known as the Porter Committee) recommended that the federal government establish a single federal agency which would take over the major responsibility for securities regulation from the provinces. The Porter Committee's recommendations were met with mixed reactions. Many felt that, while greater uniformity was desirable, inter-provincial co-operation (an alternative considered by the Porter Commission in less detail) was preferable to the establishment of a federal regulatory body.

In 1979, the federal government published *Proposals for a Securities Market Law for Canada*, which also proposed a single securities commission for Canada to regulate international and inter-provincial issues of and trading in securities.

In 1994, the federal government released a draft memorandum of understanding [20] proposing an autonomous Canadian Securities Commission to which both the federal and provincial governments would delegate regulatory power. While this most recent effort came closer than previous initiatives to achieving its goal, jurisdictional and political obstacles resulted in the effort being abandoned.

(c) Inter-provincial Harmonization through the CSA

The CSA is an informal body comprised of the 13 provincial and territorial securities regulators. It functions through regular meetings of the chairs, vice-chairs and staff of each of the commissions, through ad hoc interactions between executive directors and staff of each of the commissions, and through staff committees established to deal with joint regulatory initiatives and issues of shared concern. Funding and support resources are drawn from the operating budgets of each of the commissions on a voluntary basis. The CSA has made significant contributions to the harmonization of securities laws and the administration of those laws across Canada. Its accomplishments include the establishment of:

- "MRRS" – mutual reliance systems (discussed below) which cover, for example, applications for discretionary relief and the review of prospectuses, annual information forms and rights offering documents;

- "SEDI" – a central electronic system for insider reporting; and

- "SEDAR" – the System for Electronic Document Analysis and Retrieval which makes documents filed by reporting issuers available to anyone with access to the Internet.

Through the CSA, Canada's 13 regulators have also achieved legislative uniformity in many areas by adopting national and multilateral instruments. There are now 23 "National Instruments" – rules and regulations developed through the co-operative efforts of the CSA and subsequently adopted as law in each of the provinces and territories. National Instruments have harmonized the regulation of prospectus disclosure,[21] mutual fund regulation,[22] matters relating to early warning requirements and take-over bids,[23] registration issues[24] and marketplace operation and trading rules.[25]

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[19] See comment letter of TSX Venture.

[20] *Memorandum of Understanding Regarding the Regulation of Securities in Canada* (1994), 17 OSCB 4394.

Notwithstanding the achievements of Canadian regulators, the limitations of the CSA as a vehicle to co-ordinate Canadian securities regulations are apparent. We note four in particular:

1. Although the CSA seeks to balance national harmonization with regional flexibility, regulators in each jurisdiction are free to insist on their own approach rather than working with their counterparts in other jurisdictions to craft a common solution. This was evidenced by the revisions made to the exempt distribution rules in Ontario in 2001 and proposed in British Columbia and Alberta shortly thereafter.[26] As a result of this process, Ontario, on the one hand, and British Columbia and Alberta, on the other, will continue to have different exempt distribution rules, similar in some respects, different in others. In our view, this represents not only a missed opportunity for harmonization, but a regrettable step backwards for a more rational securities regime in Canada.

2. National policies and rules cannot be developed and implemented quickly because 13 different regulatory authorities must agree first on policy directions and then on specific requirements. The initiative must then go through the approval process applicable in each jurisdiction (in Ontario, for example, the comment period and Ministerial approval process for rules, discussed more fully in Chapter 6).

3. The CSA has no powers of enforcement, and accordingly, a co-ordinated approach to enforcement currently must be undertaken on an ad hoc basis.[27] The consolidation of Canada's capital markets and the integration of our markets with other global markets are accentuating national and international enforcement issues. We believe this is critical to the credibility of the Canadian capital markets.

4. The CSA is accountable to no one. Whether it succeeds or fails will depend on the commitment of each jurisdiction.

(d) MRRS – A Step in the Right Direction

The CSA implemented MRRS in 1999.[28] MRRS is based on a decision-maker in one jurisdiction being prepared to rely primarily on the analysis and review of staff in another jurisdiction. For example, if an issuer wishes to issue securities in more than one jurisdiction in Canada, MRRS allows the issuer to deal with one principal regulator (usually the regulator in the jurisdiction where the company's head office is located) rather than the regulators in each of the relevant jurisdictions. Staff of the principal jurisdiction provide comments to the issuer on behalf of all of the Commissions and make recommendations. The issuer then receives a single decision document from the regulator in the principal jurisdiction.

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[21] E.g., National Instrument 41-101 Prospectus Disclosure Requirements.

[22] E.g., National Instrument 81-101 Mutual Fund Prospectus Disclosure, National Instrument 81-102 Mutual Funds and National Instrument 81-105 Mutual Fund Sales Practices.

[23] E.g., National Instrument 62-103 The Early Warning System and Related Take-Over Bid and Insider Reporting Issues, and National Instrument 62-202 Take-Over Bids – Defensive Tactics.

[24] E.g., National Instrument 35-101 Conditional Exemption from Registration for United States Broker-Dealers and Agents.

[25] E.g., National Instrument 21-101 Marketplace Operation and National Instrument 23-101 Trading Rules.

[26] See for Ontario, Rule 45-501 Exempt Distributions (2001), 24 OSCB 7011 and for Alberta and B.C., Multilateral Instrument 45-103 Capital Raising Exemptions. Multilateral Instrument 45-103 became effective in Alberta on March 30, 2002. The British Columbia Securities Commission adopted MI 45-103 effective April 3, 2002.

[27] The discussion of MRRS below makes reference to the CSA's expressed intention to engage in some degree of voluntary co-operation in this area.

[28] *Memorandum of Understanding - Mutual Reliance Review System* (1999), 22 OSCB 6813.

MRRS is a formalized approach to voluntary co-operation among securities regulatory authorities. None of the regulators surrenders any jurisdiction or discretion. Each jurisdiction retains its statutory discretion with respect to all matters being considered under mutual reliance and can "opt-out" at any time and deal with the market participant directly. No changes have been made to securities laws as a result of MRRS. In fact, harmonization is not an objective of MRRS. The CSA has stated only that harmonization is "an indirect benefit that may be achieved over time" as a result of MRRS.

MRRS deals with, or is expected in the future to be extended to, the following areas:

- exemptive relief applications;
- prospectuses (including long form, short form and mutual fund prospectuses and amendments, and rights offering circulars);
- waiver applications;[29]
- pre-filing discussions;
- initial and renewal annual information forms;
- applications for registration, reinstatement of registration and renewal of registration;
- continuous disclosure documents;
- investigations and hearings; and
- rulemaking and policy making initiatives.

MRRS is a significant step forward in achieving interprovincial co-ordination. It has streamlined the regulatory process when more than one jurisdiction is involved. However, we share the reservations expressed in a number of submissions about the limitations of MRRS. For example, the Canadian Association of Insurance and Financial Advisers wrote:

> While we have come to appreciate the ability of a lead regulator to co-ordinate a series of interprovincial applications, we believe that the potential for mutual reliance remains to be realized. For example, there can be little justification for the continuing need to file individual paper applications to each regulator and to pay fees for amounts that vary from $0 to $750 to each regulator when the lead or co-ordinating regulator charges $450 and does most of the work.

We note the following limitations of MRRS in particular:

- MRRS does not ensure uniformity in the administration of securities laws across Canada. Each jurisdiction retains the right to interpret and apply national instruments in its own way and to apply its own local requirements to whatever issues come before it. In addition, a regulator can "opt out" of MRRS when it disagrees with the decision reached by the principal regulator. The possibility that one or more regulators could opt out means that MRRS has created neither a predictable nor a uniform approach to securities regulation.
- MRRS has not reduced regulatory costs. Staff in the non-principal jurisdictions may undertake an independent review on multi-jurisdictional filings. Market participants are still subject to payment of the same fees in each jurisdiction as were payable prior to the adoption of mutual reliance.
- Securities laws are not uniform across all jurisdictions. Differences exist, for example, with respect to prospectus offerings, exemptions from the prospectus and

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[29] These are applications for relief that are evidenced by the issue of a receipt for a prospectus.

registration requirements, take-over bids, continuous disclosure and enforcement powers. MRRS does not alleviate the need for market participants to be familiar with, seek advice on, and comply with the different requirements that exist across the country. There is considerable cost associated with this exercise.

1.3 The Final Push for a National Securities Regulator

(a) What Is the Appropriate Model?

In order for Canadians to have world-class opportunities both to raise capital and to invest their savings, a dramatic change in the structure of our regulatory regime is required. The ongoing consolidation and internationalization of markets around the world demands that we be less focussed on provincial and territorial concerns and more focussed on national and international harmonization. We believe that the solution is the establishment of a single securities regulator with responsibility for the capital markets across Canada, but with regional offices so that territorial concerns are taken into consideration. There is an urgent need to put this issue back on the policy agenda of our respective governments and regulators.

Many of the submissions made to the Committee support the creation of a single Canadian securities regulator. For example, the Ontario Teachers' Pension Plan Board, one of Canada's largest institutional investors, endorses a single regulator as a means of establishing and enforcing appropriate regulatory standards across the country:

> We come at the problem of regulatory harmonization in the securities area from a deliberately naïve perspective, and prefer to put political and constitutional issues aside in articulating our position. We recognize that, in fact, coming to the "sensible" conclusion for Canada is not straightforward. A national system of securities regulation is the desirable end result. No matter how good Ontario gets, if the system is based on harmonization and co-operation, and other jurisdictions have less good standards and enforcement capabilities, there will be a "race to the bottom". Issuers will earn the right to raise money in the capital markets in less rigorous regulatory environments, get listings in the premium markets, and tarnish the reputation of the entire country. The provinces need to recognize that Canada is suffering as a destination for business and capital because they refuse to give up jurisdiction to a first class regulatory regime that is administered and enforced by a first class regulator. Canada needs to get on one page in securities administration if it hopes to compete globally.[30]

Another commenter also supports a single regulator:

> With respect to the efficiency of our regulatory model, we believe that much work needs to be done to reduce the duplicative and costly system of provincial regulation that exists in Canada. While much effort has been expended in making our current system operate more effectively, it is simply not credible to argue that the involvement of multiple regulators that exists within the CSA can achieve the efficiency of a national securities regulator.[31]

We also believe that international co-operation and collaboration would be made much easier for Ontario (and Canada) through a single securities regime. Under our current regulatory regime, it is not entirely clear who, if anyone, speaks for Canada.

The Committee makes no recommendation about how a single Canadian securities regulator should be constituted. Previous proposals for a federal regulator could be revived, with efforts renewed to remove the remaining road blocks. Alternatively, a supra-provincial body to which the provinces and territories delegate their authority could be established. Other models may also be proposed as this project moves forward.

(b) A Lesson from Australia

During the Committee's deliberations, we heard with interest about the recent experience in Australia, where securities regulation was recently rationalized along national lines. From a starting point prior to 1970 when corporate and securities laws were matters of state and territorial jurisdiction, through a number of failed initiatives designed to harmonize their approach to securities regulation, the states and territories of Australia ultimately agreed to the enactment of federal legislation dealing with corporate and securities law which draws on state and territorial powers as well as federal powers. The result was the creation of the Australian Securities Commission (now the Australian Securities and Investment Commission) as the national regulator, with full responsibility for the regulation of companies. The Australian experience is described in Appendix F.

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[30] See comment letter of the Ontario Teachers' Pension Plan Board.

[31] See comment letter of Torys.

We found the Australian experience instructive because of the range of alternatives that were explored before a solution was achieved. The constitutional issues in Australia are similar to those we face in Canada, as are issues of inter-jurisdictional co-operation. The Canadian solution may well be different from the Australian solution. However, we encourage all levels of government in Canada and securities regulators in every jurisdiction to follow the Australian lead.[32] We believe that creativity and compromise will result in a system that allows Canadian issuers and investors to function more effectively in the global marketplace.

(c) Moving Forward in the Meantime

As we move to establish a single Canadian securities regulatory regime, we must also continue to move forward with our harmonization efforts. This will allow Canadian capital markets to benefit from the economies of harmonization on an incremental basis and will smooth the path to a single regulator.

(i) Harmonization of Securities Laws

If Canada's 13 provinces and territories could harmonize their securities laws, this would go a long way to simplifying capital markets regulation in Canada. It is clearly an enormous endeavour requiring significant resources, time, and political will in order to harmonize legislation in the first instance and then to make amendments to each jurisdiction's legislation in a co-ordinated and harmonized way on an ongoing basis. We understand that the CSA is currently exploring how this might be accomplished.[33]

(ii) Delegation and Mutual Recognition

Even if securities laws across the country were harmonized, this would not eliminate the administrative duplication inherent in having 13 regulators administering and enforcing those laws. In our view, the most efficient interim solution to deal with this issue is for each of the jurisdictions to move expeditiously to amend their legislation in two ways. First, securities regulators must be empowered to delegate authority to a securities regulator in another Canadian jurisdiction – moving from our current system of voluntary mutual reliance to a system of true reliance. This would eliminate the need for staff in each jurisdiction to undertake an independent review of a multi-jurisdictional filing and would eliminate the entitlement of individual jurisdictions to opt out. It must be recognized, however, that the effectiveness of this proposal will ultimately depend on the willingness of all CSA jurisdictions to enact similar provisions ceding jurisdiction. On a practical level, it will also be imperative that each CSA jurisdiction exercise regulatory restraint and truly rely upon the body to which it has delegated authority.

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[32] Several judicial decisions had cast doubt on the constitutionality of Australia's framework for corporate regulation. See Ian Ramsay, *The Unravelling of Australia's Federal Corporate Law*, (http://cclsr.law.unimelb.edu.au/Bulletins/Bulletin0031.htm) for a full discussion of the relevant cases. In response to these judicial decisions, legislation was recently introduced in which Australian states referred their constitutional powers with respect to corporate regulation and the regulation of the securities and futures industries to the Australian Commonwealth. See the *Australian Securities and Investment Commission Act*, 2001 (No. 51, 2001), s. 11.

[33] See CSA Notice 11-303 The Uniform Securities Legislation Project (March 8, 2002).

Second, securities laws across the country must be amended to provide for "mutual recognition" – i.e., where a securities regulator may deem that compliance by a market participant with securities laws in another specified jurisdiction constitutes compliance with securities laws in the regulator's own jurisdiction. The concept of mutual recognition forms the basis of the Canadian – U.S. Multi-Jurisdictional Disclosure System ("MJDS"). It also implicitly underlies other rules which provide exemptive relief from the need to comply with Canadian law provided the laws of certain foreign jurisdictions are complied with instead. If compliance with foreign law is viewed as a satisfactory proxy for compliance with Canadian securities regulatory requirements, we believe that Canadian regulators should be able to put aside historical differences and regional preferences to conclude that where requirements in different provinces are similar (albeit not identical), compliance with the laws of another province will constitute compliance with the laws of their province.

We recognize that there may be constitutional and other legal issues that will need to be addressed in implementing this proposal. For example, consequential amendments to the Act's immunity provisions may be necessary to extend immunity from liability to other provincial securities regulators and their employees who act as delegatees.[34] We encourage the CSA to work on implementing an effective delegation model and we urge the provincial governments across Canada to support this important initiative.

Recommendations:

1. **We recommend that the provinces, territories and federal government work towards the creation of a single securities regulator with responsibility for the capital markets across Canada.**

2. **In the meantime, we recommend that certain steps be undertaken by securities regulators to continue to harmonize securities regulation across Canada. Harmonizing provincial securities legislation would significantly simplify securities regulation in Canada. We also recommend that securities regulators be given the authority to delegate any power, duty, function or responsibility conferred on them to another securities regulatory authority within Canada, and that they actively engage in delegation among themselves. We recommend the Act be amended to give the Commission this authority, and that the necessary consequential amendments to the immunity provisions in the Act be made. In addition, we recommend that securities legislation across the country be amended to provide for "mutual recognition" – that a securities regulator may deem that compliance by a market participant with securities laws in another specified Canadian jurisdiction constitutes compliance with securities laws in the regulator's own jurisdiction.**

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[34] The Act, subsection 141(1).

Chapter 2: Thinking Globally in Securities Regulation

"Globalization" is more than just a catch phrase in the context of capital markets. Increasingly, issuers are able to raise capital in whatever market around the globe offers them the best arrangements while investors are able to trade on a variety of exchanges around the world.

This chapter describes the impact of globalization on the Canadian capital markets and proposes two areas in which Canada should take the steps necessary to be a global participant. It also endorses the Commission's participation in IOSCO.

2.1 The Need to Harmonize Globally

The globalization of capital markets is evidenced by a number of trends, including:

- the growth of cross-border securities transactions;
- an increasing number of additional listings of Canadian companies on foreign exchanges;
- the emergence of multinational securities firms servicing businesses from offices across the world; and
- an increasing number of strategic alliances and other connections between regulated financial markets in different parts of the world.[35]

Canadian issuers have looked to the U.S. market in particular, whether to obtain a listing on NASDAQ or the NYSE, access the investment grade or high yield debt market or simply to broaden their financing prospects. Many Canadian issuers have listings on U.S. stock exchanges.[36] The introduction of MJDS in 1991 facilitated access to the U.S. capital markets by Canadian reporting issuers and vice versa.

The restructuring of the stock exchanges is an example of thinking globally to remain competitive. Ten major stock exchanges around the world (including the TSX) have announced an alliance named "The Global Equity Market" ("GEM") that will eventually permit 24-hour-a-day, around-the-world trading of blue chip securities.[37] Similarly, an electronic stock exchange (Nasdaq Canada) has been established in Quebec, which will ultimately link to other Nasdaq markets. Five derivative trading exchanges from around the world, including the Bourse de Montréal, have formed a global trading alliance (GLOBEX Alliance), offering common access to a range of derivative products.

2.2 Financial Reporting for Global Accessibility

(a) Current GAAP Requirements

Ontario securities and corporate laws currently require Canadian reporting issuers to prepare their financial statements in accordance with Canadian GAAP. Foreign reporting issuers may use the accounting principles of their home country, but must provide a reconciliation to Canadian GAAP for financial statements in a prospectus.[38]

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[35] Allan Cameron, *The Globalization of the Securities Market* (Seminar on the Globalization of Securities, Allen Allen & Hemsely, August 16, 1999).

[36] As of January 31, 2002, 208 TSX-listed companies were interlisted on a U.S. market. For the year 2001, U.S. markets represented 53.4 per cent of the volume and 55 per cent of the value of stocks interlisted with the TSX.

[37] The GEM alliance also includes exchanges in the United States, Japan, Australia, Hong Kong, Mexico, Brazil, France, the Netherlands and Belgium.

[38] Foreign reporting issuers are not required to provide a reconciliation for continuous disclosure filings under Ontario securities law. We understand, however, that such a requirement is often imposed as a condition of obtaining a continuous disclosure exemption frequently provided to foreign companies.

Canadian issuers who access the U.S. capital markets often consider it desirable to provide financial information to the U.S. marketplace that conforms to U.S. GAAP. This enhances the ability of American investors and analysts to understand the issuer's financial performance and to compare it to the performance of other issuers who report in U.S. GAAP. However, this requires the Canadian issuer to prepare two complete sets of financial statements, one in Canadian GAAP to satisfy Canadian legal requirements and one in U.S. GAAP. Foreign issuers who access the Canadian capital markets have the same problem in reverse, although they more often elect to simply provide a reconciliation to Canadian GAAP. Preparing two sets of financial statements or a reconciliation is both time consuming and expensive for the issuer.

(b) CSA Discussion Paper

The CSA recently issued CSA Discussion Paper 52-401 Financial Reporting in Canada's Capital Markets (the "Financial Reporting Discussion Paper") for comment.[39] It notes that "the growth of cross-border financing activity has focussed attention on impediments to companies wishing to offer their securities or have them listed in another jurisdiction." It identifies differences in accounting standards as one such impediment. The CSA is seeking comment on possible changes to existing requirements dealing with accounting standards used for financial statements filed by issuers. In particular, the CSA is considering whether Canadian and foreign reporting issuers should be permitted to use U.S. GAAP or the international accounting standards ("IAS") developed by the International Accounting Standards Committee (the "IASC"), which were recently endorsed by IOSCO, with limited or no reconciliation to Canadian GAAP.[40]

The Financial Reporting Discussion Paper identifies several issues that need to be considered in deciding whether to accept IAS or U.S. GAAP for regulatory filings in Canada:

- Comparability – Having as many as three sets of accounting standards for reporting issuers would make it difficult for Canadian investors and analysts to compare results for different companies. The CSA acknowledges, however, that the peer group for some Canadian companies comprises foreign companies that do not prepare Canadian GAAP statements.
- Professional Capacity – Canadian accounting professionals have limited knowledge of U.S. GAAP and virtually no experience with IAS. A significant effort would be required for companies, auditors and regulators to build expertise to support a rigorous interpretation and application of such standards.
- Other Statutory Requirements – Even if the CSA were to permit Canadian companies to prepare their financial statements in accordance with U.S. GAAP, companies may still be required under corporate or tax statutes to file Canadian GAAP financial statements. The potential benefits flowing from a CSA exemption will only be fully realized if these other requirements can also be changed.

(c) The Time Has Come to Move Away from Canadian GAAP

We share the concerns expressed in the Financial Reporting Discussion Paper that the current multitude of accounting standards involved in cross-border offerings and listings can make it very difficult to compare financial information from issuers based in different countries. We encourage the move by Canadian regulators and standard setters to IAS and hope that Canada will continue to play a leadership role in this area. The Financial Reporting Discussion Paper specifically contemplates permitting foreign issuers reporting in Canada to use financial statements prepared in accordance with IAS without reconciliation to Canadian GAAP. We support the CSA's deliberations on this matter.

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[39] (2001), 24 OSCB 1678.

[40] Since the early 1990s, IOSCO has been working with the IASC to develop a set of standards that could be accepted by all regulators for cross-border offerings. In May 2000, IOSCO completed its assessment of the suitability of 30 accounting standards developed by the IASC. IOSCO approved a resolution recommending that its members permit the use of the IASC standards, supplemented by reconciliation, disclosure and interpretation as necessary to address outstanding substantive issues at a national or regional level. The Canadian Accounting Standards Board (the "AcSB") has been working with major foreign standards-setting bodies toward the convergence of accounting standards. The goal of convergence is to develop IAS as a single set of internationally accepted accounting standards. The AcSB has also been working to eliminate the major differences between Canadian and U.S. accounting standards.

While we support the development of suitable international accounting standards, a more pressing issue for Canada at this time is whether reporting issuers (both Canadian and foreign) should be permitted to prepare their statements in accordance with U.S. GAAP without reconciliation to Canadian GAAP. In this regard, we do not think that we can afford to ignore the vast amount of cross-border activity that exists between Canada and the U.S.[41] When an issuer competes with other issuers who prepare their statements in accordance with U.S. GAAP, the investors (and issuers) may be at a disadvantage if financial statements are reported in accordance only with Canadian GAAP.

There are differences between U.S. and Canadian GAAP. For example, Canadian accounting standards are, generally speaking, less prescriptive and rule oriented than U.S. standards, thereby providing more scope for the application of professional judgment. There are also substantive differences in specific areas, such as accounting for foreign currency transactions and inventory accounting. In some cases, these differences can have very significant effects on the way in which the results of operations are reported. Nevertheless, Canadian standard setters have been working over the years to reduce the number of differences between Canadian and U.S. GAAP.[42] Consequently, we question whether the remaining differences between Canadian and U.S. GAAP are so significant that they should preclude the use of U.S. GAAP by Canadian and foreign companies. Moreover, given the familiarity of the Canadian investment community with U.S. GAAP, we are not convinced that there is any investor protection function being served by insisting on statements prepared in accordance with Canadian GAAP in these situations.

We received a number of submissions supporting use of U.S. GAAP in financial statements that are required to be filed with the Commission.[43] The IDA noted that "[i]ndividual investors would not be disadvantaged if Canadian corporations reported in U.S. GAAP." Another commenter stated:

> My vision is that any company could raise capital in Canada and satisfy its reporting obligations by preparing its documents in accordance with Canadian GAAP, U.S. GAAP, or International GAAP, without reconciliation to a Canadian benchmark. I believe that U.S. GAAP must be permitted, in spite of a world wide desire for common global standards, until such time as the U.S. embraces International standards as acceptable for primary financial statements within U.S. borders. Although not without its faults, U.S. GAAP is arguably the most comprehensive and sophisticated set of accounting principles in the world. ...
>
> The driving factor behind acceptance of a set of standards should not be local views as to what is the "right" accounting, but recognition that the standards have been developed by a competent body with sufficient resources, processes and input from all interested parties that the product can be considered high quality. I think that can now be said of both International and U.S. accounting standard setting.

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[41] According to Statistics Canada data for 2000, the United States provides Canada with approximately 63.9 per cent of its total foreign direct investment (cited in Todd Evans, "Foreign Direct Investment Monitor" (August 2001) http://www.edc-see.ca/docs/country/economics/fdimonitor/fdimon_e.pdf).

[42] For example, there has been harmonization, or work in progress to achieve harmonization, between U.S. and Canadian GAAP in the following areas: cash flow statements, methods of recording income taxes, segment information, accounting for R&D arrangements, and accounting and reporting of stock based compensation.

[43] See comment letters of KPMG, Michael Tambosso of PricewaterhouseCoopers, the IDA, and Simon Romano of Stikeman Elliot.

> ...Although, as I noted earlier, there are differences even in a "harmonized" world, I don't believe that the nuances in the differences are sufficient to require a reconciliation to aid a user's understanding of the financial statements. (I like Molson's Joe, and like him, I am Canadian, but I don't think that we need to be so "Canadian" that we won't let people read and interpret International and U.S. GAAP financial statements without a Canadian GAAP interpretation beside it.) There is nothing so unique about Canadian standards that a Canadian user is placed at undue risk by relying on financial statements prepared in accordance with...U.S. standards (recognizing that a user should be reasonably well-informed to start, and actually read and interpret the financial statements and notes). Moreover, as noted, it is critical that we turn to the processes by which the standards are developed, and not personal or local views on specific outputs.[44]

The Committee received no submissions opposing the proposal to allow both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP without reconciliation to Canadian GAAP.

We recognize that the acceptance of U.S. GAAP raises some challenging transitional issues, such as the degree of professional capacity which exists in Canada to deal with U.S. standards. However, the benefits that will accrue to issuers and investors eclipse the challenges that these issues present. At the same time, however, it will be appropriate to require that Canadian issuers that choose to prepare only U.S. GAAP financial statements provide a reconciliation to Canadian GAAP for a transitional period. This would maintain a link to the information that Canadian investors have been accustomed to receiving. Whether and when the transitional period would end should be determined by the regulators, who would take into account whether eliminating the requirement for reconciliation would raise significant comparability issues for analysts and investors.

We also recognize that the Enron crisis has raised some questions about U.S. GAAP. These issues are being addressed by various groups in the United States and are being followed closely in Canada. Notwithstanding these issues, we believe that it will continue to be important for Canadian issuers to be able to stay in step with requirements imposed by U.S. regulations without duplicating efforts for Canadian reporting purposes.

Recommendations:

1. **We recommend that the Commission and the CSA permit both foreign and Canadian companies to prepare their financial statements in accordance with U.S. GAAP. Issuers who prepare their financial statements in accordance with U.S. GAAP should be required to reconcile the statements to Canadian GAAP during a transitional period. The duration of the transitional period should be determined by the regulators taking into account whether significant comparability issues will arise if no reconciliation is provided.**

2. **We encourage the move by both Canadian regulators and standard setters to International Accounting Standards and hope that Canada will continue to play a leadership role in this area.**

2.3 The Book-Based System

Legislation in Canada dealing with the transfer and pledging of securities was developed at a time when securities were held under what is referred to as the "certificated system" – the owner of the security was shown in the issuer's records as the registered holder and received a certificate evidencing its interest. If the holder wished to transfer or pledge its interest, it delivered the certificate to the purchaser or the pledgee and the issuer amended its records to show the purchaser as the registered holder of the certificate. In the case of a pledge of securities, the pledgee either simply held the certificate to prevent the pledgor from selling or pledging the security to someone else or required that it be shown as the registered holder in the issuer's records and a new certificate was issued to it.

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[44] See comment letter of Michael Tambosso of PricewaterhouseCoopers.

Today, securities held by Canadian investors and by investors in other parts of the world are most commonly held through various "book-based systems." Under a book-based system, a security is not registered in the name of the person who owns that security. Instead, it is registered in the name of an intermediary – typically a securities dealer, bank, custodian or central securities depository. Trades are recorded by way of entries made in records maintained by the intermediaries.

In commercial transactions, issues arise over how to evidence the transfer of a security or pledge of a security held in a book-based system. If the purchaser or pledgee is not confident that its interest in the security is recognized under the laws of the relevant jurisdiction, it will attribute more risk to the transaction. Lack of harmonization can make the transferring and pledging of securities within and between book-based systems inconvenient and, in some cases, altogether unmanageable.

There is a need for a nationally harmonized (and ultimately globally harmonized) regulatory regime to oversee the holding, transferring and pledging of securities. Action has been taken in this regard in many parts of the world, including the United States. In the United States, Article 8 of the *Uniform Commercial Code* ("UCC"), which governs transfers and pledges of securities, was revised in 1994 to deal with securities held through the book-based system as well as the certificated system. No such changes have been made to legislation in Ontario[45] or elsewhere in Canada. This creates legal uncertainty for Canadian market participants active in cross-border securities trading and pledging transactions. It places them at a competitive disadvantage vis-à-vis market participants in the United States, the European Union and certain other jurisdictions that have reformed their conflict-of-laws rules in this area of law.

After the enactment of revised Article 8 of the UCC, the Uniform Law Conference of Canada established a committee to study the issue of law reform in Canada. It proposed the adoption of a uniform provincial *Securities Transfer Act* ("STA") in Canada substantially modelled on UCC revised Article 8. This project has been ongoing for a number of years in Canada. It has most recently been taken up by a CSA Task Force on Securities Settlement Rules, which is to oversee the drafting of the STA legislation by a consortium of provincial legislative counsel from provinces including Ontario. The need to update the legislation in Canada is clear and compelling. Canadian legislation in this area is currently out of step with legislation in the United States and certain other countries. The legal foundation for the transfer of securities is a fundamental component of the clearing and settlement process, and of efficient and safe capital markets.

Recommendation:

We encourage the Commission and the CSA to continue developing securities transfer legislation modelled on revised Article 8 of the *Uniform Commercial Code* in the United States and we urge governments across Canada to ensure that such legislation is adopted on a uniform basis.

2.4 Participation in IOSCO

Securities regulators from around the world have sought to harmonize their approach to regulation through IOSCO.[46] Established in 1975, IOSCO promotes mutual co-operation among members through discussion of matters such as market regulation policies and the development of international standards in securities regulation. Over the years, the Commission has been an active participant in IOSCO.

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[45] The relevant legislation is the *Business Corporations Act*, R.S.O. 1990, c. B-16 and the *Personal Property Securities Act*, R.S.O. 1990, c. P-10.

[46] IOSCO is a worldwide association of regulatory bodies with responsibility for securities regulation and the administration of securities laws. IOSCO aims to foster co-operation among its members, promote high standards of securities regulation, facilitate the exchange of information and encourage the establishment of standards and effective surveillance of international securities transactions. For more information, see the IOSCO website at www.iosco.org.

IOSCO has completed or has work in progress on a range of matters, including:

- international accounting standards for cross-border reporting purposes;
- disclosure standards for cross-border initial public offerings and listing of equity securities;
- cross-border screen-based trading;
- global securities lending; and
- improving and harmonizing standards for regulated exchanges and clearing houses.

IOSCO is not a global securities regulator, nor does it have any authority to adopt and implement binding international regulatory principles. While the establishment of a true global securities regulator has intuitive appeal given the nature of today's capital markets, we believe that the practical approach for dealing with globalization is currently to increase the degree of collaboration and co-operation between securities regulators in different countries.

Recommendation:

We encourage the Commission to continue its ongoing participation in IOSCO initiatives and urge the Commission to adopt, in a timely fashion, changes to its rules to implement the international standards emanating from IOSCO.

Chapter 3: Securities Regulation – Only Part of the Capital Markets Picture

3.1 History of Regulation of Financial Markets in Canada

Until 1987, regulation of Canadian financial markets was based on the "four pillars" structure of financial services delivery. Institutions forming each of the four pillars had the exclusive right to provide a core financial service. Banks offered loans and accepted deposits; insurance companies sold insurance; trust companies provided estate and trust services and offered mortgages; and securities firms underwrote public offerings and sold securities to the public.[47] There was little overlap between products and services, and each pillar was governed by its own legislation and regulator.

The rules separating the four pillars were eliminated in 1987[48] and each of the four types of providers began to offer products and services in areas from which they previously had been excluded. Notwithstanding this change, each type of institution (and the products and securities they offer) continues to be regulated by its own statute. As a result, similar activities or products are regulated in a different fashion depending on the nature of the financial institution offering the product or service.

For example, mutual funds and segregated funds are functionally equivalent from the viewpoint of the investor. Each is a managed pool of funds that is invested in a variety of instruments including debt instruments and equity. Mutual fund units or shares are securities and are therefore governed by securities regulation. They are subject to very detailed rules regarding: how they are structured and organized; disclosure in respect of the product, which must be precleared by securities regulators and given to purchasers; conflicts of interest for portfolio managers of mutual funds; and fees which must be disclosed to purchasers. Segregated funds, on the other hand, are structured as contracts of insurance and therefore are not considered "securities" for purposes of the Act. They are instead governed by the requirements of the *Insurance Act*[49] and are not subject to the same type of regulation in respect of disclosure, conflict of interest, sales practices and fees as are mutual funds. A retail investor may buy an interest in both a mutual fund and a segregated fund and, despite the similarity of the products, enjoy different types of protection.

The regulation of portfolio managers is another example. Portfolio managers buy and sell securities for their clients on a discretionary basis. Their clients are pension funds, estates, mutual funds, segregated funds and private clients. While their function is the same for all types of clients, the standards and requirements imposed on portfolio managers are significantly different, depending on where the portfolio manager works. Portfolio managers licensed by the securities commissions are subject to the highest standards of education and experience of any category of registration under securities legislation. On the other hand, trust company employees making investment decisions for estates and pension administrators investing pension funds are not subject to any proficiency requirements under federal or provincial financial institution or pension legislation. The rules designed to protect clients from conflicts of interest in the portfolio manager's investment decision making, and those governing the conduct of the portfolio manager in the market (such as prohibitions on

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[47] David A. Brown, Q.C., *After MacKay. Re-aligning Financial Services Regulation. A Framework for Market Regulation in Canada* (Remarks given at the Securities Superconference, February 24, 1999).

[48] The Hockin-Kwinter Accord of April 28, 1987 between the Minister of Finance of Canada and the Minister of Financial Institutions for the Province of Ontario introduced a new regime for the regulation of federal financial institutions (banks, federal trust and loan companies, and federal insurance companies) and their subsidiaries and affiliates.

[49] R.S.O. 1990, c. I.8.

"front running" client orders) differ substantially.[50]

Finally, considerable regulatory uncertainty exists concerning the regulation of trading in securities by pension plans. In Canada, there has been a move away from defined benefit plans (in which the employer is responsible for operating the plan, investing its assets, and paying a defined monthly benefit to eligible pensioners), toward defined contribution pension plans (DC) or group registered retirement savings plans (RRSP). In some DC plans and in group RRSPs, the employee makes the decision about how to invest his or her portion of the plan assets, choosing from a range of investment options made available by the plan sponsor. It is the employee who bears the risk of the investment decision in terms of what the employee's ultimate pension benefit will be.

Current securities legislation provides that securities can be sold to a pension plan without having to comply with the prospectus and registration requirements of the Act if the securities are sold by a financial intermediary directly to the plan or its sponsor and there is no communication with or disclosure to the employees.[51] This exemption may have made sense for defined benefit pension plans, where the plan administrator often retained qualified money managers to manage the investments of the plan and the employee was not making any investment decision, such that the protections of the Act were considered unnecessary. However, the Committee believes that the approach to regulating DC plans and group RRSPs should be revisited to ensure that employees who make their own investment decisions receive adequate disclosure and investor protection.

3.2 The Current Regulatory Response - Functional Regulation

(a) Background

On February 24, 1999, the CSA issued a concept paper entitled "A Framework for Market Regulation in Canada" (the "Concept Paper").[52] The Concept Paper began by reviewing the historical basis for regulation in Canada and noted the regulatory mismatches that have arisen because of the continuing institutional nature of regulation in Canada. The Concept Paper advocated a move toward a "functional mode of regulation":

> Clearly, the framework [for regulation] should be improved and all levels of government should expand their initiatives to eliminate unnecessary duplication and overlap in the regulatory system. However, the nature and degree of the mismatches in the system lead to the conclusion that there is a need for something more than incremental improvements. It is time for a more comparable regulatory treatment of similar market services and products regardless of the way in which those products and services are packaged or the nature of the institution offering them. In Canada a more effective regulatory framework for the financial services industry would be achieved by moving to a functional mode of regulation. Functional regulation allocates regulatory responsibilities along regulatory objective parameters: usually divided between prudential regulation and market (or consumer protection) regulation.[53]

The focus of functional regulation is on activities and particular products rather than on the nature of the institutions that carry on the activities or offer the products or services. Functionally equivalent or similar products and services are given similar regulatory treatment even when they are provided by very different entities.[54] The Concept Paper would vest market regulation for all financial services providers in the provinces and territories. The provincially-based market regulators would be responsible for oversight of market conduct, integrity of markets and consumer protection including:

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[50] *A Framework for Market Regulation in Canada – A Concept Paper Prepared for the Canadian Securities Administrators* (1999), 22 OSCB 1290 [hereinafter the "Concept Paper"].

[51] OSC Rule 32-503 "Registration Exemption for Certain Trades by Financial Intermediaries" (1997), 20 OSCB 699.

[52] *Supra* note 50 at 1299.

[53] *Supra* note 50 at 1292.

[54] *Supra* note 50 at 1301.

- consumer protection regimes applicable to all financial institutions;
- market integrity rules governing market conduct of all participants in securities markets;
- the regulation of securities, derivatives and futures markets; and
- oversight of industry SROs.

(b) Proposed OSC/FSCO Merger

On September 8, 2000, the Ministry of Finance released a discussion paper entitled "Improving Ontario's Financial Services Regulation: Establishing a Single Financial Services Regulator – a Discussion Paper."[55] Among other things, this discussion paper proposes a merger of the Commission and the Financial Services Commission of Ontario. This merger would effect a form of functional regulation similar to that proposed by the CSA in the Concept Paper. The merged entity, the Ontario Financial Services Commission, would regulate securities, pension, insurance and other financial services sectors in Ontario and would provide a level playing field in respect of disclosure, proficiency, market conduct and market integrity for participants in these markets in Ontario.[56]

(c) Joint Forum of Financial Market Regulators

The CSA, the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities established the "Joint Forum of Financial Market Regulators" (the "Joint Forum"). This is a national forum of pension, securities and insurance regulators established to discuss common issues arising from the growing integration of the financial services sector. In its fall 2000 newsletter, the Joint Forum notes that its agenda continues to focus on regulatory harmonization in the following areas:

- proficiency requirements for financial planners;
- individual variable insurance contracts [segregated funds] and mutual funds;
- investment disclosure in capital accumulation plans [i.e., defined contribution, group RRSP, deferred profit sharing]; and
- intermediary proficiency and licensing.

On April 27, 2001, the Joint Forum released for comment a consultation paper on capital accumulation plans, which proposes broad regulatory principles for disclosure and other regulatory protections for capital accumulation plans.

(d) International Trends Toward Functional Regulation

Finally, on an international level, the Committee notes that, in Australia in 1999, all financial institutions were brought under the supervision of three regulators: the Australian Securities and Investments Commission (which regulates market conduct of members of the securities, banking, insurance and pension industries), the Australian Prudential Regulation Authority and the Reserve Bank of Australia. Meanwhile, in the United Kingdom, the FSA has become the sole regulator of the financial services industry.

3.3 One Step Further – Harmonized Functional Regulation

In the Committee's view, the ideal regulatory model in Canada would be one of "harmonized functional regulation." This combines the harmonization of securities regulation across the country as recommended in Chapter 1 and functional regulation as discussed above. Under this approach, regulation would distinguish between market conduct and products, on the one hand, and prudential issues on the other. All market activities would be regulated by one market conduct regulator and by one prudential regulator. All products and services, and the behaviour and conduct of those manufacturing and selling them, would be under the regulatory jurisdiction of a market regulator. This regulator could continue to rely on recognized SROs, as appropriate. All matters relating to fiscal solvency of the institutions would fall under the auspices of a prudential regulator. This is the model that has been adopted in Australia. This is contrasted with the model adopted in the United Kingdom, which brings market and prudential regulation under the auspices of a single regulator – the FSA.

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[55] Ontario, Ministry of Finance at http://www.gov.on.ca/FIN/english/pubseng.htm.

[56] In April 2001, the Ministry of Finance released for comment a Consultation Draft of the proposed merger legislation. Comments were due June 29, 2001. At the same time, it should be noted that FSCO is moving away from prudential regulation of insurance companies in Ontario. Effective July 1, 2004, all loan and trust companies wishing to carry on business in Ontario will be required to be federally incorporated and subject to solvency regulation by OSFI, at the federal level (See *An Act to implement measures contained in the 2001 Budget and to amend various statutes*, S.O. 2001, c. 8, s. 75).

The Committee is aware, however, that a move from the current Canadian model of separate provincial regulation of securities laws, on the one hand, and regulation of insurance companies, pension plans, trust companies and financial institutions, on the other hand, to a fully harmonized and integrated model of regulation cannot occur overnight. Incremental steps need to be taken.

As discussed previously in Chapter 1, we strongly recommend a harmonized system of securities regulation in Canada. While harmonized national securities regulation will result in a rationalized approach to regulating the securities industry in Canada, it will not eliminate the current inconsistencies discussed above in regulating functionally similar products and services. It is therefore also desirable, in our view, to pursue the harmonization of functional regulation nationally. The model we envisage would result in a single financial services regulator with jurisdiction over market conduct and products, services and activities in the financial markets regardless of which institution is offering the product or service or engaging in the activity. Consumer and investor protection has long been the forte of provincial regulators. We urge federal regulators to participate in a model that extends provincial expertise to areas not traditionally dealt with by the federal regulators, rather than federal regulators beginning to occupy the field of consumer protection for institutions that are federally regulated, as recently proposed. In this joint initiative model, the federal regulator would have responsibility for prudential regulatory matters, reflecting its traditional area of expertise.

We recognize that the proposed merger in Ontario between the Commission and FSCO appears to be advancing and acknowledge that, if the merger is implemented, it could make it more difficult to achieve our vision of national securities regulation, particularly if the other provinces do not adopt a structure similar to the merged Ontario structure.[57] We urge those involved in the Commission/FSCO merger process to consider whether the structure they propose is flexible enough to accommodate the establishment of national securities regulation in a timely manner.

Recommendation:

We recommend that the CSA, provincial and territorial governments and the federal government move to adopt a system of harmonized functional regulation across Canada, whereby all Canadian capital market activities, products and conduct are regulated by a single market conduct regulator and fiscal solvency matters are regulated by a single prudential regulator.

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[57] The Government of Saskatchewan is considering a proposal to establish a single regulatory body with broad responsibilities respecting the regulation of financial services, including lending, securities, pensions, insurance, deposit taking, trust services and other financial products and services. See Saskatchewan Department of Justice, *Reorganizing the Financial Services Regulators In Saskatchewan: The Saskatchewan Financial Services Commission* (November 2001) (www.saskjustice.gov.sk.ca). In December 2001, a Quebec ministerial task force released a report recommending the creation of a single agency that would be responsible for the entire financial sector regulatory system, including insurance, securities, deposit institutions, the distribution of financial products and services and pension plans. See Report of the Task Force on Financial Sector Regulation, *A Streamlined Regulatory Structure for Quebec's Financial Sector* (December 2001).

PART 2
FLEXIBLE REGULATION

The purposes of the Act set out the foundation upon which the securities regulatory framework is built. In turn, this regulatory framework needs to be flexible enough to adapt to a changing marketplace. In Part 2 of this report, we discuss issues relating to the basic structure of the Act such as its purposes and principles, rulemaking and the impact of the Internet on securities regulation.

Chapter 4: Objectives of the Act

4.1 Purposes of the Act

We considered whether the purposes set out in the Act are appropriate. The Act sets out two purposes (the "Statutory Purposes"):

> 1.1 The purposes of this Act are,
>
> (a) to provide protection to investors from unfair, improper or fraudulent practices; and
>
> (b) to foster fair and efficient capital markets and confidence in capital markets.

In reviewing the Statutory Purposes, we reviewed comparable provisions (to the extent they exist) in securities legislation in the United States, the United Kingdom and Australia.[58] We are satisfied that section 1.1 provides the Commission with a mandate that is appropriate and largely consistent with the mandate of other foreign securities regulators.

4.2 Principles to Consider

The Act directs the Commission to have regard to the following six fundamental principles in pursuing the Statutory Purposes (the "Principles Clause"):

> 2.1 In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles:
>
> 1. Balancing the importance to be given to each of the purposes of this Act may be required in specific cases.
> 2. The primary means for achieving the purposes of this Act are,
>   i. requirements for timely, accurate and efficient disclosure of information,
>   ii. restrictions on fraudulent and unfair market practices and procedures, and
>   iii. requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants.
> 3. Effective and responsive securities regulation requires timely, open and efficient administration and enforcement of this Act by the Commission.
> 4. The Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized self-regulatory organizations.
> 5. The integration of capital markets is supported and promoted by the sound and responsible harmonization and co-ordination of securities regulation regimes.
> 6. Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance

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[58] Both the U.K. and Australian regulatory regimes have recently undergone a very thoughtful process of review and revision.

> of the regulatory objectives sought to be realized.[59]

We identified the following additional considerations which are set out in securities regulation in other jurisdictions and which we believe should be added to the Principles Clause:

- advancing investor education;
- maintaining the competitive position of the home country in light of the international character of capital markets;
- facilitating innovation in connection with regulated activities; and
- facilitating and promoting competition between those who are subject to regulation.

(a) Investor Education

Individual Canadians are investing in the capital markets in increasing numbers.[60] With access to on-line research, advice and trading, individuals are becoming more directly involved in managing their own investments. In this environment investor education has taken on a new urgency. Retail investors face a bewildering array of choices. To be successful they need to understand the basics of investing and saving, know how to check out an investment or salesperson, and how to protect themselves against possible fraud. We therefore recommend that the Act should be amended to direct the Commission, when discharging its mandate, to consider the principle that effective and responsive securities regulation should promote the informed participation of investors in the marketplace. We note that the Commission has devoted considerable attention and resources to investor education in recent years.[61]

(b) Ontario's Place in Global Capital Markets

In Part 1 of this report, we discussed the importance of Canadian capital markets being competitive on a global basis. Globalization of financial services, coupled with advances in information technology, mean investors are no longer geographically bound. Cross-border, 24-hour trading is already commonplace. If our markets are healthy and vibrant, investors will choose Canada. If our markets do not measure up to international standards, investors will bypass Canada and seek quality elsewhere. We therefore recommend that the Act should be amended to direct the Commission, when discharging its mandate, to consider the impact of securities legislation on Ontario's competitive position in global capital markets.

(c) Facilitating Innovation

In recent years we have seen the development of new technologies, new financial products, new market participants and new trading methods. Such financial innovations should be encouraged. They reduce costs and enable investors to better manage their money. Regulators should work with the securities industry to facilitate innovation. In particular, participants should be encouraged to discuss new product ideas and new market developments with the regulators at an early stage to ensure that the risks and regulatory implications are properly understood and managed. Similarly, regulators should avoid unreasonable barriers to entry or restrictions on market participants launching new products. We therefore recommend that the Act be amended to direct the Commission, when discharging its mandate, to consider the principle that innovation should be facilitated.

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[59] Sections 1.1 and 2.1 of the Act were enacted pursuant to the 1994 Amendments on the recommendation of the Daniels Committee. Section 2.1 was enacted as a result of concerns that there would be little to gain from having just a mandate section predicated on broadly defined purposes. Section 2.1 lists several principles that both "common sense and the actual practices of the Commission dictate should be and have been used to direct and structure the Commission's interpretation of the Act's purposes in the context of specific cases, problems and regulatory initiatives." See the Daniels Report, *supra* note 7 at page 3235.

[60] "Roughly one half of all working Canadians are directly and indirectly invested in the equities market. Over the past ten years, Canadian investors' holdings of securities have doubled to more than $550 billion today. Ten years ago, 22 per cent of the average investor's financial assets (bank accounts, RRSPs, pension, insurance, etc.) were stocks. Today this share has grown to 30 per cent." (Investment Dealers Association, Canadian Securities Industry Profile http://www.ida.ca/indissues/indprofile.en.asp).

[61] For example, the Commission participates, along with other members of the Council of Securities Regulators of the Americas, in an annual "Investor Education Week" to heighten public awareness of the capital markets, the role of regulators and the information resources available to investors. In June 2000 the Commission also established the Investor e•ducation Fund to develop and support initiatives that educate investors.

(d) Competition Among Market Participants

Competition among market participants is the main engine for innovation and in general works to consumers' best interests. The Commission should seek to ensure that its rules and policies do not impede or distort competition. In particular, it's important to maintain a level playing field among all market participants. We therefore recommend that the Act should be amended to direct the Commission, when discharging its mandate, to consider the principle that competition among regulated persons and entities should not be unnecessarily impeded.

Recommendation:

We recommend that section 2.1 of the Act be amended to direct the Commission to have regard to the following additional principles in pursuing the objectives of the Act:

- **Effective and responsive securities regulation should promote the participation of informed investors in the capital markets.**
- **Capital markets are international in character and it is desirable to maintain the competitive position of Ontario's capital markets.**
- **Innovation in Ontario's capital markets should be facilitated.**
- **The administration and enforcement of Ontario securities law should not unnecessarily impede or distort competition among persons carrying on regulated activities.**

Chapter 5: Structure of the Act

5.1 Should the Act Be Overhauled?

Since the Act first came into force in 1945, it has evolved into a complicated maze of legislation, regulations, rules and interpretative policies. The Act itself is less than 150 pages. However, its provisions must be read together with over 2,000 additional pages of regulations, rules (including national instruments), policy statements, notices, communiqués and clarification notes which restrict the provisions of the Act in some cases and supplement them in others. The result is a fragmented regulatory scheme which is accessible only to highly specialized practitioners.

The Committee considered whether Ontario should abandon the current Act and start again, this time adopting a more streamlined approach to securities regulation. This could be accomplished, for example, by enshrining broad principles and standards of market behaviour (together with enforcement authority) in the statute, with detailed requirements set out in rules that would be subject to ministerial approval. This kind of an exercise would only make sense if it could be done in the context of a national initiative. We are concerned that an overhaul of the Act in Ontario alone would exacerbate the differences in legislation that already exist across the country.[62]

Rulemaking has provided increased flexibility to our system of regulation. Ontario securities law has become easier to develop, adopt and amend. Accordingly, we recommend that future legislative initiatives move in the direction of broad principles being enshrined in the Act and detailed requirements contained in the rules. Although we make some recommendations to further streamline the rulemaking process, the ability of the Commission to make rules, if combined with some housecleaning of the Act, will have moved us a significant way along the road to a more manageable set of regulations, particularly if the CSA's uniform securities law project achieves its objective.

5.2 Enshrining Core Concepts

Concepts that are fundamental to securities regulation should be enshrined in the Act. Some already are, but others are buried in the regulations. For example, the Act itself provides that: a person must be registered to trade a security or act as an adviser; a prospectus must be prepared in order to distribute securities to the public; minority shareholders cannot be excluded from a take-over bid; public companies must provide certain information to their shareholders; and insiders may not misappropriate material undisclosed information for their own benefit. However, the concept that registered dealers and advisers "deal fairly, honestly and in good faith with clients" is not set out in the Act, although this must surely be considered a cornerstone of securities regulation in Ontario. This principle is contained in a rule.[63] The Committee believes that principles as fundamental as this should be enshrined in the Act. We invite comments from interested parties on other significant provisions that should be set out in the Act, rather than in a regulation or rule.

The detailed requirements that support the fundamental concepts of the Act should be moved from the Act to the rules. For example, the Act could provide that all exemptions from the prospectus requirement are provided for by a rule. This will ensure the Act remains a more manageable piece of legislation and will allow the Commission to amend the detailed requirements more easily to respond to changing circumstances in the marketplace.

5.3 Housekeeping Amendments

The Act is cluttered with outdated provisions that have been superseded by rules. One example is the exemption from the prospectus requirement available for trades made by an issuer of its own securities with its employees. There is an exemption for such trades in the Act.[64] However, there is also a rule[65] which eliminates this exemption and replaces it with a different exemption and conditions for using that exemption. Yet it is unclear on a plain reading of the Act whether and to what extent the rule affects the exemption contained in the Act. In situations such as these, the Act should be amended to reflect the fact that the Act has been amended or supplemented by a rule. Such housekeeping amendments should be included in the Minister's legislative agenda on a regular basis.

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[62] As we discussed in Chapter 1, we believe that Canadian securities regulators should move towards greater harmonization.

[63] OSC Rule 31-505 Conditions of Registration, subsection 2.1(2).

5.4 Plain English

The Committee believes Ontario securities law should be written in a style that is clear and easy to understand. As part of the Reformulation Project, proposed instruments must be accompanied by explanatory notices and Companion Policies; these notices and Companion Policies provide an opportunity for accessible explanations both of changes to the regulatory regime and of new regulatory initiatives. We understand that the CSA has embarked on a plain language initiative and we encourage these efforts.

Recommendations:

1. **The Act should be amended to the extent necessary to ensure that the basic principles underlying our approach to securities legislation are contained in the Act.**

2. **The Commission, together with the Ontario government, should seek to streamline the Act by incorporating detailed requirements in the rules. In addition, the Committee believes that the Act should accurately reflect current law. This may result in certain exemptions being removed from the Act altogether where they have been superseded by a rule.**

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[64] The Act, clause 72(1)(n).

[65] OSC Rule 45-503 Trades to Employees, Executives and Consultants.

Chapter 6: Rulemaking

The Commission was given rulemaking authority as a result of the 1994 Amendments. The Committee reviewed the Commission's rulemaking process and concluded that although rulemaking works well, it needs to be streamlined.

6.1 Background

Prior to 1994, the Commission regularly issued policy statements. These policy statements did not receive legislative or ministerial approval, but were treated as having legal effect, both by the Commission and by capital market participants. In 1993, however, the court in the Ainsley decision found that one of the Commission's policy statements was invalid on the basis that the Commission had "exceeded its jurisdiction under its enabling legislation in promulgating it."[66]

With the validity of policy statements under challenge as a result of this decision, there was a need to find a way to provide these instruments with legislative legitimacy. In October 1993, the Ministry and the Commission established the Daniels Committee. The Daniels Committee recommended that the Commission be given rulemaking authority, subject to appropriate accountability and transparency controls.[67] The Ontario government accepted this recommendation and provided the Commission with rulemaking authority as part of the 1994 Amendments.

As a result of the Ainsley decision and the 1994 Amendments, the Commission began the process of reviewing all of its existing policy statements, notices and blanket rulings in order to either reformulate them as rules, policies or staff notices or eliminate them. This process is commonly known as the "Reformulation Project."[68] The Commission has also undertaken a number of new rulemaking and policy making initiatives to keep pace with a changing marketplace. A significant number of the regulatory instruments considered during the Reformulation Project were national instruments; accordingly, securities regulators in other jurisdictions participated in this process. The need to ensure co-ordination among numerous provincial and territorial regulators has made the process more complex and resource intensive. In some cases, this multi-jurisdictional approach to rulemaking has hindered timely and expeditious securities policy making and regulation.

The Reformulation Project is nearing completion. It has been an enormous undertaking not only for the Commission and other members of the CSA, but also for market participants and their advisers who have been operating in a changing regulatory environment and who have been asked to comment on a plethora of both reformulated instruments and new instruments. We expect that the completion of this project will alleviate some of the concerns expressed by market participants in their submissions regarding the number of new rules and policies.

6.2 Scope of Rulemaking Authority

The matters in respect of which the Commission has the authority to make rules are specifically listed in the Act.[69] These "heads of rulemaking power" were intended to provide sufficient authority for the Commission to make rules dealing with those matters that were previously the subject of policy instruments, as well as securities regulatory matters which might arise in the foreseeable future. There is no "basket provision", however, that would allow the Commission to make rules with respect to matters within its legislative mandate but which were not specifically contemplated under the heads of its rulemaking power.

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[66] In *Ainsley Financial Corporation* v. *Ontario Securities Commission* (1993), 14 O.R. (3d) 280 (General Division), the court declared invalid a Commission policy statement respecting the sale of penny stocks because the Commission exceeded its jurisdiction.

[67] See the Daniels Report, *supra* note 7.

[68] Since 1995, the Commission has reviewed approximately 300 regulatory instruments.

[69] For example, the Commission may make rules regulating the listing or trading of publicly traded securities including requiring reporting of trades and quotations.

In the absence of a basket provision, the Commission must seek a legislative amendment to the heads of rulemaking authority if the Commission wishes to introduce a rule that is within its legislated mandate, but which does not fall within the specific heads of rulemaking authority set out in the Act. This occurred during the Reformulation Project, when it became apparent that the Commission did not have sufficient legislative authority to support the conversion of certain existing policy statements into rules. These "lack of authority issues" arose in connection with certain prospectus disclosure rules (such as the mutual fund and general prospectus rules) and procedural rules for distributions under a prospectus (such as the prompt offering qualification system and the shelf system).[70]

The Alberta and British Columbia Securities Commissions and the SEC each have a basket provision as part of their rulemaking heads of authority. The Alberta Securities Commission is authorized to make rules governing "any other matter related to the carrying out of the Act or the conduct of the business and affairs of the Commission." The British Columbia Securities Commission may make rules "for the purpose of regulating trading in securities or exchange contracts, or for the purpose of regulating the securities industry or the exchange contract industry." The SEC is authorized under six different statutes to adopt whatever rules and regulations may be necessary or appropriate to carry out its statutory functions. The reason for such a broad grant of powers was the "imperative to protect investors against fraud or deception made possible by constantly changing conditions."[71]

We understand that commenters to the Daniels Committee opposed the inclusion of a basket provision in the heads of rulemaking authority out of concern that the authority of non-elected officials to make binding law had to be specifically circumscribed. Notwithstanding these comments, the Daniels Committee recommended in its final report that the Commission retain the authority to make rules "respecting any other matter authorized by or required to implement any provision of this Act."[72] The Ontario government did not accept this recommendation. We recommend that such a provision be added to the rulemaking provisions in the Act. There must be a balance between legitimate concerns relating to legislative authority and the need for regulatory responsiveness and flexibility. We believe that piecemeal legislative amendments to broaden the heads of rulemaking authority unnecessarily slow down the rulemaking process. We also believe that Ministerial approval would act as an effective check to ensure that the Commission acts within the proper scope of its authority. Future five year reviews would also afford an opportunity to consider whether the Commission has exercised this authority appropriately.

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[70] The Daniels Report stated, for example, that the Commission should receive rulemaking authority to enable it to reformulate former National Policy Statement No. 44 Shelf Prospectus Offerings. However, the head of authority given to the Commission under the 1994 Amendments was not sufficiently broad to capture the entire shelf regime. The Act requires prospectuses to be renewed annually. The shelf regime allows shelf prospectuses to remain in force for two years, after which time they must be renewed. The Commission's rulemaking authority did not permit the Commission to extend the one year period prescribed by the Act by way of a rule. As a result, in Ontario, amendments were made to the Commission's rulemaking authority in December 1999 to permit proposed National Instrument 44-101 Shelf Distributions to be adopted without the need for issuers to apply for and obtain discretionary relief in order for a receipt for a base shelf prospectus to be effective for more than one year.

[71] *R.A. Holman & Co., Inc.* v. *SEC*, [1962] 2999 F.2d 127, 132 (D.C. Cir.) cert. denied, 370 U.S. 911, quoted in L. Loss and J. Seligman, *Securities Regulation*, 3rd ed. (Boston: Little, Brown & Company, 1993) at 4915.

[72] The Daniels Committee also considered a broader formulation that would authorize rules respecting any matter that, in the opinion of the Commission, was "necessary or advisable for carrying out the purposes and provisions of the Act". The Daniels Committee noted that provisions of this type are frequently found in regulation-making provisions of Ontario and federal statutes. Ultimately, the Daniels Committee recommended the narrower formulation, although we note that this recommendation was never picked up in the 1994 Amendments. In reaching its recommendation, the Daniels Committee gave the following reasons:

- the Commission's heads of authority are intended to be comprehensive, both in terms of the number of matters listed and in terms of the scope of the rulemaking authority that is provided for with respect to the listed matters;
- a responsibly limited basket provision would be more consistent with the innovation of the Commission's rulemaking versus a more broadly drafted provision; and
- periodic resort to the legislature for amendments to the Commission's heads of rulemaking authority is expected and desirable. (The Daniels Report, *supra* note 7 at page 3255.)

Recommendation:

We recommend that the Commission be given "basket" rulemaking authority that is substantially identical to that conferred on the Lieutenant Governor in Council pursuant to clause 143(2)(b) of the Act. The Commission should be given the authority to make rules respecting any matter that, in the opinion of the Commission, is "necessary or advisable for carrying out the purposes of the Act."

6.3 The Need to Streamline the Rulemaking Process

Rulemaking permits flexibility and responsiveness in securities policy making and regulation. In general, capital market participants are supportive of the Commission's rulemaking authority and believe that rulemaking is an effective regulatory tool.[73] There is, however, concern with the time required to make a rule.[74] It generally takes a minimum of 18 months to put a national or multilateral rule in place. Changes occur in the markets much more quickly than that. Ontario needs to adopt a more streamlined rulemaking process, subject to maintaining appropriate accountability and transparency controls.

The Committee considered what improvements could be made to streamline the rulemaking process. Alberta and British Columbia each has a rulemaking process similar to that in Ontario, with several important differences: the length of the comment period; requirements to republish for comment; and the process for obtaining Ministerial approval.[75] We considered whether conforming the rulemaking process in the Act to the approach in either of these provinces would achieve our streamlining objective and facilitate the adoption of harmonized regulation across the country without compromising the public consultation process or the prerogative of the Minister to consider the Commission's regulatory initiatives.

(a) Length of Comment Period

Ontario provides longer periods for public comment than any of the other jurisdictions we considered. The Alberta Act prescribes a 30 day initial comment period for rules and imposes no notice or comment requirements for policy statements. British Columbia prescribes a 60 day initial comment period for rules and there is no prescribed comment period for policies. The comment period for SEC rules typically varies between 30 and 60 days.[76] In contrast, Ontario prescribes a 90 day initial comment period for rules and a 60 day initial comment period for policies. We think that 60 days is a sufficient period of time to allow for comments for rules. We would be concerned that 30 days may be inadequate, given the number of other matters competing for the attention of the people from whom the Commission wishes to have input and the fact that rules carry the force of law. However, we think that a 30 day comment period is sufficient for policies, which only set out guidance from the Commission on the interpretation of Ontario securities law.

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[73] See comment letters of the Alberta Securities Commission, the Ontario Teachers' Pension Plan Board, the IDA, Torys, TSX Venture, CICA, Osler, Hoskin & Harcourt LLP, Simon Romano, Glorianne Stromberg, the Canadian Association of Insurance and Financial Advisers, and the British Columbia Securities Commission.

[74] See comment letters of the IDA, Torys, TSX Venture, and the Canadian Association of Insurance and Financial Advisers.

[75] For example, the British Columbia Securities Commission must seek ministerial approval in principle prior to publishing a rule and ministerial consent once it has made a rule. The Commission must seek ministerial approval once it has made a rule. The Alberta Securities Commission does not need to obtain formal ministerial approval either prior to or following the adoption of a rule.

[76] "How the SEC Rulemaking Process Works", SEC website, http://www.sec.gov/about/whatwedo.shtml.

There have been many rules and policies issued for comment in response to which the Commission has received very few comment letters from investors, market participants or their advisers. We understand that commenting on a rule or policy proposal can be a time-consuming exercise, but we feel strongly that those who have a role in our capital markets also have a responsibility to participate in the comment process. We encourage those players to be more responsive to the Commission's request for comments. We do not believe that a 60 and 30 day comment period for rules and policies, respectively, should adversely impact on the ability of market participants and their advisers to respond to requests for comments.

Recommendation:

We recommend that the minimum initial comment period for rules be reduced from 90 to 60 days and that the minimum initial comment period for policies be reduced from 60 to 30 days.

(b) Republication for Comment

The Act requires the Commission to republish a proposed rule or policy for comment if the Commission "proposes material changes" to the rule or policy. This is an objective test and the Commission has erred on the side of caution in determining whether to republish. Under both the Alberta and B.C. statutes, republication is required if the Commission proposes to make an amendment to a proposed rule that the Commission considers to be a material change. In other words, the determination is left to the expert tribunal in British Columbia and Alberta. In the United States, a subsequent comment period is not required for SEC rules, provided that the final rule is a "logical outgrowth of the rulemaking proceeding when viewed in light of the original proposal and call for comments." The U.S. test provides some guidance to the SEC as to when republication is warranted.

The Committee received comment letters advocating that the Commission have more flexibility and discretion to decide when republication of a proposed rule or policy is warranted.[77] The Committee agrees with the commenters. We found numerous examples of instruments which were republished for comment three or four times.[78] In such cases, it is not unusual for the process to take three to four years. It is not clear to us that the benefits of republication always outweigh the resulting delays in the rulemaking process. In the interests of efficiency, we believe that the Commission should have more discretion to decide when republication for comment is necessary.

There are control mechanisms in place to ensure that the Commission does not abuse its discretion when determining when republication is warranted. All rules made by the Commission must be approved by the Minister before they can become effective. The Minister has the power to return a rule to the Commission for further consideration and, in this context, could ask that the rule be republished for comment.[79] We propose an alternative approach that is based on elements of the U.S., B.C. and Alberta tests for republication, with additional guidance built in.

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[77] See comment letters of the IDA and TSX Venture.

[78] See, for example, the publication history of OSC Rule 31-502 Proficiency Requirements for Registrants; OSC Rule 41-501 General Prospectus Requirements; Rule 61-501 Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions; and OSC Rule 91-504 Over-The-Counter Derivatives.

[79] Since rulemaking was introduced in Ontario, the Minister has returned three rules to the Commission for further consideration: (i) OSC Rule 31-506 SRO Membership - Mutual Fund Dealers; (ii) Multilateral Instrument 33-107, "Proficiency Requirements for Registrants Holding Themselves out as Providing Financial Planning and Similar Advice"; and (iii) OSC Rule 91-504 Over-the-Counter-Derivatives.

Recommendation:

We recommend that the Act be amended to require that the Commission republish for comment a proposed rule only if the Commission proposes changes to a rule that the Commission considers to be material, having regard to:

(a) the nature of the changes proposed to the rule as a whole; and

(b) whether the final rule is a logical outgrowth of the rulemaking process when viewed in light of the original rule proposal and request for comments.

We further recommend that a similar test be adopted for the republication of policy statements.

(c) Ministerial Approval

Once the Commission has finalized a rule, the rule must be delivered to the Minister for approval, accompanied by supporting documentation, and must be published in the Bulletin. Within 60 days of a rule being delivered to the Minister, the Minister must approve the rule, reject the rule or return the rule to the Commission for further consideration. If the Minister takes no action in the 60 day period, then the rule will come into force 15 days later.

In looking for ways to streamline the rulemaking process, we considered whether the Minister could do with less time to review a rule. We understand that the Commission keeps the Minister's staff apprised of its rulemaking initiatives, including the schedule for delivering rules to the Minister for approval. With the appropriate advance notification and briefings, we believe that the approval period can and should be shortened to 30 days. We further note that the Reformulation Project is winding down, which should mean significantly fewer proposed rules being sent to the Minister than has been the case in the last six years.

Recommendation:

We recommend that the period for Ministerial approval of rules be shortened from 60 to 30 days.

(d) Crowded Agenda

We believe that the Commission's internal processes slow the rulemaking process. In this regard, we note the number of initiatives that the Commission has on its policy agenda at any given point in time and the length of time that it often takes the Commission to complete them. It seems to us that the Commission may be trying to do too much. When rules take years to complete, the problems or inefficiencies they are intended to address continue. We are also concerned that the number of initiatives on the Commission's rulemaking agenda has discouraged capital markets participants from being fully engaged in commenting on proposed rules.

We recommend that the Commission review its procedures to determine where bottlenecks occur. It should then establish internal standards that set out acceptable timeframes for staff to review and respond to comments received on a rule or policy proposal. Staff should report to the Commission annually on its performance against these standards.

Recommendation:

We urge the Commission to limit the number of projects that it takes on and focus its resources on fewer critical policy issues. We further recommend that the Commission streamline its internal rulemaking process by, among other things, focussing on fewer policy projects and establishing internal standards for the development of rule and policy proposals, including benchmark timeframes for reviewing and responding to comments on a rule or policy proposal.

6.4 Cost-Benefit Analyses

The Commission is required to publish in the Bulletin a notice of every rule it proposes to make.[80] That notice must include "a description of the anticipated costs and benefits of the proposed rule."[81] Accordingly, both draft and final rules contain a section dealing with costs and benefits. This disclosure has often been boilerplate, providing a general overview of the benefits of the proposed regulation and certain of its costs. It is common to find the following statement made at the close of such a discussion: "based on experience to date, the Commission believes that the benefits of the proposed rule justify the costs."[82] Notices have seldom included any empirical data in support of these conclusions.[83]

In contrast, the SEC often sets out the specific costs and benefits associated with proposed regulation.[84] The SEC urges commenters to provide empirical evidence to assess whether proposed regulation will promote the efficiency of securities markets and the confidence of capital market participants.[85]

The Committee believes that, as a general practice before implementing regulation, securities regulatory authorities should solicit, commission or conduct empirical studies with the objective of enabling regulators to assess the effectiveness, costs and benefits of the proposed regulation. This cost-benefit analysis should include, where possible, a description of background materials and empirical evidence relied on. This affords investors and market participants the opportunity to digest and challenge the Commission's analyses through the comment process and/or provide additional empirical evidence for the Commission's consideration.

However, there will be occasions when it is either unnecessary or not feasible to collect and assess empirical data and to perform the recommended cost-benefit analysis. In some cases, even if it is possible to collect certain data, it may not be possible to conduct a statistically significant analysis with it. In cases where the Commission does not complete more detailed cost-benefit analyses prior to the introduction of new regulation, it should explain why it was not feasible to do so.

Recommendation:

The Commission should undertake, as appropriate, cost-benefit analyses to assess the effectiveness of proposed regulations. The Commission should make public these cost-benefit analyses. If no analyses are completed, the Commission should specifically explain why they were not.

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[80] The Act, subsection 143.2(1).

[81] The Act, subsection 143.2(2).

[82] See, for example, Notice of Proposed Rule 33-503 Change of Registration Information, Rescission of Notice and Revocation of Regulations under the Securities Act, http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/33-503_rule.html (September 17, 1999); Notice of OSC Rule 31-507 "SRO Membership – Securities Dealers and Brokers", http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/31-507_oscrule_20000630.html (June 30, 2000).

[83] In a recent concept proposal for a new fee structure issued by the Commission, the accompanying Notice included a very helpful economic analysis of the impact of the concept proposal on capital market participants (Notice and Request for Comments 11-901 Concept Proposal to Revise Schedule 1 (Fees) to the Regulation to the Securities Act (Ontario) (2001), 24 OSCB 1971). We encourage the Commission to continue to include analyses of this nature, and of the type we discuss, in future rules.

[84] SEC, "Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate", 17 CFR Part 270, Release No. IC-24775; File No. S7-20-00, RIN 3235-AH57, or online at http://www.sec.gov/rules/proposed/ic-24775.html.

[85] A typical statement from an SEC Release requesting comments from capital market participants on a given subject reads, "The Commission requests comment on all aspects of this cost-benefit analysis, including identification of additional costs or benefits of the proposed changes. The Commission encourages commenters to identify or supply any relevant data concerning the costs or benefits of the proposed amendments." See, for example, SEC, "Firm Quote and Trade-Through Disclosure Rules for Options" 17 CFR Part 240, Release No. 34-43085; File No. S7-17-00, RIN 3235-AH96, or online at http://www.sec.gov/rules/proposed/34-43085.htm#link17.

6.5 Blanket Rulings and Orders

Blanket rulings and orders[86] are rulings or orders of general application issued by a securities regulator that exempt classes of trades, securities, companies, transactions and other matters from regulatory requirements otherwise applicable.[87] Blanket rulings and orders apply to anyone who fits the terms of the order and obviate the need for a particular capital market participant to seek a separate ruling or order from the Commission on an ad hoc basis. Blanket rulings and orders eliminate costs, delay and uncertainty caused by individual applications for discretionary relief. The ability to issue blanket rulings and orders in connection with non-contentious recurring situations provides the regulator with another useful tool to address changes in the marketplace in a timely manner.

The Daniels Committee recognized the importance of blanket rulings and orders to a modern system of securities regulation. In its interim report, the Daniels Committee noted:

> If properly utilized, the blanket ruling constitutes an effective means for incremental policy-making by the Commission. Specifically, the blanket ruling permits the Commission to exercise its discretionary exemption powers in respect of a class of cases involving similar or identical facts with which the Commission has had considerable regulatory experience. Blanket rulings permit the parties to avoid the costs and uncertainty of regulatory hearings in respect of matters where the Commission's thinking has crystallized.[88]

The Daniels Committee ultimately decided that, if the Commission were to receive rulemaking power, there would be little need for the Commission to continue its use of blanket rulings and orders. It recommended including exempting rules, which would be subject to notice and comment requirements, within the Commission's general rulemaking power:[89]

> Replacing the blanket ruling instrument with exempting rules would have the benefit of simplifying the regime through the reduction of the number of regulatory instruments used. Most significantly, however, the resulting exempting rules would be subject to the notice and comment requirements and the cabinet disapproval period that we recommend for rules generally – requirements that the Commission is not statutorily bound to adhere to presently. On a going forward basis, we regard these procedural protections as appropriate and necessary given the rule like character of the blanket rulings and orders.[90]

The Ontario government accepted the recommendation of the Daniels Committee and eliminated the Commission's authority to issue blanket rulings and orders as part of the 1994 Amendments.[91] We received comment letters, however, that support reinstating the Commission's power to issue blanket rulings and orders to respond in a timely manner to emerging issues of general concern.[92]

We believe that blanket rulings and orders complement rather than undermine the rulemaking process. The weekly Bulletins abound with examples of applications for relief routinely given by the Commission. It would be much more efficient for the Commission to issue a blanket ruling or order when it becomes apparent that there is a general need for exemptive relief. For example, instead of issuing identical rulings and orders to individual applicants on a weekly basis, the Commission could have issued blanket rulings and orders to:

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[86] Orders are granted pursuant to the Commission's exempting powers in ss. 83, 144 and 147 of the Act. Rulings are granted pursuant to the Commission's exempting power in subsection 74(1) of the Act.

[87] Prior to the 1994 Amendments, the Commission had the ability under various statutory exemption powers to issue blanket rulings and orders. For example, the Commission had the power under subsection 121(2) of the Act to exempt any class of persons or companies or class of transactions from the requirements of Part 21 of the Act.

[88] The Daniels Report, *supra* note 7 at page 22.

[89] For example, paragraphs 8 and 20 of subsection 143(1) of the Act give the Commission authority to make rules for exemptions from the registration and prospectus requirements under the Act or for the removal of exemptions from those requirements.

[90] The Daniels Report, *supra* note 7 at page 3223.

[91] The Commission is now prohibited under s. 143.11 of the Act from making any orders or rulings of general application.

[92] See comment letters of the British Columbia Securities Commission and Torys.

- permit mutual funds to track stock market indices without violating concentration limits;
- grant registration and prospectus relief in respect of exchangeable shares transactions; and
- permit related underwriters to act as underwriters in connection with a distribution of securities of a connected issuer subject to appropriate conditions.

While we believe that the Commission should once again have the ability to issue blanket rulings and orders, we are sensitive to concerns relating to proliferation of regulatory instruments and Ministerial accountability. Therefore, we recommend that any blanket ruling or order be subject to a sunset clause of three years from the date of the introduction of the blanket ruling or order. This will provide the Commission with sufficient time to prepare a draft rule on the topic of the blanket ruling or order, issue it for public comment and submit it for Ministerial approval.

Recommendation:

We recommend that the legislation be amended to allow the Commission to issue blanket rulings and orders that provide exemptive relief only. We further recommend that blanket rulings and orders be used only as an interim measure. Therefore, they should be subject to a sunset period under which any blanket ruling or order issued by the Commission will automatically expire in three years unless converted sooner into a rule.

6.6 Publication of Exemption Requests Granted or Denied under Rules

Currently, when the Commission grants an exemption pursuant to the Act, the order granting the exemption is published in the Bulletin, allowing others to understand the reasons for the granting of the exemption. The Commission has not yet universally adopted this approach with respect to exemptions granted from securities rules.[93] We believe that market participants would benefit from such transparency. We therefore recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also urge the Commission to consider providing notice when exemptive relief applications are not granted, and of the reason for the refusal.

Recommendation:

We recommend that the Commission publish exemption orders granted from the requirements of securities rules. We also urge the Commission to consider whether there should be some notice when exemptive relief applications are not granted, and of the reason for the refusal.

6.7 Review of Ontario Securities Law

The Act requires that the Minister of Finance establish an advisory committee every five years to review the legislation, regulations and rules relating to matters dealt with by the Commission and the legislative needs of the Commission.[94] We are the first such committee to be established. As discussed in the Introduction, the Minister will be required to appoint the next committee in 2004. That may follow too soon upon the submission of our final report. In addition, we anticipate that, since our Draft Report constituted such a broad survey of securities legislation, subsequent Ministerial committees will be able to focus their mandate more narrowly.

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[93] By way of exception, the Commission does publish exemption orders granted under OSC Rule 61-501 Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions.

[94] The Act, s. 142.12.

Recommendation:

We recommend that the Act be amended to require that future review committees be appointed five years after the date of delivery of the final report of the previous committee, in contrast to the current requirement which prescribes that committees be appointed every five years.

Chapter 7: The Impact of the Internet

7.1 Overview

The Internet has created a new environment for companies, dealers, advisers and other intermediaries as well as for investors. Websites, bulletin boards, e-mail and push technology permit real-time, widespread and low cost communication. Research indicates that the Internet is not just an information channel: it has blurred the lines between information on the one hand, and advice, sales and promotion on the other hand.[95]

As a communication vehicle the Internet impacts a number of issues such as registration, enforcement and proxy solicitation. Reporting companies are using the Internet to conduct public offerings, communicate with shareholders and potential investors, and conduct shareholder meetings. Intermediaries are using the Internet for marketing purposes, and for communicating with, and receiving orders from, potential investors. Retail investors are using the Internet to open and maintain accounts online, to trade without the assistance of a registered intermediary,[96] to communicate with other investors and as a research and investment tool.[97] The Internet is also providing retail investors with direct access to an unprecedented amount of information, previously available only to institutions and "sophisticated" investors.

The Committee considered the extent to which the Act requires amendment in response to the use of the Internet by capital market participants. The issues we thought about in this context include:

- the conduct of offerings over the Internet;
- satisfying delivery obligations by the Internet; and
- substituting postings on the Internet as a proxy for satisfying delivery obligations.

We also consider in Chapter 8 the impact of the Internet on registration issues, including the emergence and regulation of financial portals and the obligation to conduct suitability determinations with regard to investors who trade securities over the Internet.

Finally, the Internet has also created new avenues for fraud. This is because the Internet offers a medium that is fast, cheap, easy to use, and relatively anonymous. In Part 6, we make a number of recommendations aimed at strengthening the Act's enforcement regime which should also assist in enhancing the Commission's efforts to deal with online securities fraud.

7.2 Application of Existing Regulation to Internet Communications

(a) Policy Guidance in Interpreting Existing Regulation

The CSA has twice issued interpretative policy guidance identifying issues to consider when using Internet communications in the context of activities regulated by the Act. These policies, National Policy 47-201 "Trading in Securities Using the Internet and Other Electronic Means" and National Policy 11-201 "Delivery of Documents by Electronic Means," do not make any changes to the Act. Market participants must still adhere to the requirements in the Act and subordinate legislation even if they are communicating electronically with each other. These policies set out guidelines but allow "participants to determine how they wish to comply with corporate and securities law requirements."

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[95] Bank Works Trading Inc., *Making Money on the Web 2001: The Web and Other Channel Preferences* (March 2001) www.bankworks.com.

[96] Eighty-seven per cent of affluent online investors (i.e., average $100K-125K household income and $100K-160K of investable assets) use an adviser to some degree. Thirty-three per cent of affluent investors, whose primary investment provider is a discount broker, say they receive no financial advice. *(Ibid.)*

[97] Fifty-nine per cent of Canadians have direct in-home or office Internet access, but a far smaller percentage is doing meaningful activity (Ipsos-Reid, Canadian Telecom & IT Review, Third Quarter, 2000 (http://reailinteractive.ca)). Research and tracking are the dominant activity among affluent investors, with 95 per cent using the Internet for research. *(Ibid.)*

We encourage the Commission to monitor the need for further guidance with regard to Internet communications and update the relevant policy statements as necessary. For example, guidance could be issued discussing instances in which hyperlinked documents will be considered by the CSA to form a part of a company's disclosure record and the types of website disclosure that may attract civil liability.

7.3 Electronic Commerce Act

Ten months after the CSA adopted National Policy 11-201 and National Policy 47-201, the Province of Ontario passed the *Electronic Commerce Act, 2000* (the "ECA").[98] Similar legislation has either been tabled or passed in other provinces.

The objective of the ECA was to "cut red tape and remove outdated legal barriers to e-commerce" in order to bring Ontario laws in line with technological advances.[99] The ECA ensures that electronic contracts, documents and signatures have the same legal effect as contracts, documents and signatures on paper; sets rules for automated transactions; adopts national and international standards for e-commerce law; and requires consent for the provision of information in electronic form.

There is potential for inconsistencies and even conflict between the two CSA National Policies and the ECA. A potential conflict could arise for an issuer, for example, if it were trying to determine whether it could deliver financial statements to shareholders, who had provided their consent, by posting these statements on the issuer's website. National Policy 11-201 suggests that delivery obligations can generally be satisfied by posting the relevant documents on a website if the investor has consented. In contrast, the ECA sets out circumstances in which merely making electronic information or documents available for access at a website will not constitute effective delivery. While our purpose is not to undertake an exhaustive review and comparison of the provisions of National Policy 11-201 and the ECA, we note that there are other provisions of the ECA that raise issues as to its impact on the guidance afforded by National Policy 11-201.

We believe the guidance offered by these National Policies has been helpful to many participants in the capital markets and that it is important that market participants be able to continue to rely on these policies. To the extent there is inconsistency between the ECA and the National Policies, or perceived inconsistency, the CSA should amend the Policies, reformulate them as rules if necessary, or issue a notice providing guidance on how the ECA and the National Policies interact.

Recommendation:

The Committee recommends that the CSA consider whether NP 11-201 and NP 47-201 conflict with provincial legislation such as the ECA. The Committee believes that the CSA should ensure that the guidance provided by it continues to be operative.

7.4 Internet Offerings

There have been some examples in the United States, and to a lesser extent in Canada, of issuers raising capital by offering securities on the Internet. Internet offerings conducted without the involvement of an underwriter are referred to as "direct public offerings" (or "DPOs"). In 1998, e-minerals exploration corp., a Canadian junior mining company, completed the first DPO in Canada. Investors were permitted to subscribe for the offered shares by completing the online subscription agreement available at the website and submitting it electronically via the Internet. Since that time there have been no pure DPOs, although some companies have offered their securities over the internet in conjunction with conventional sales by underwriters (e.g., flowthru.com, 1999) In addition, in the United States, offerings of debt securities over the Internet by various governmental bodies are gaining increasing success and popularity.

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[98] S.O. 2000, c. 17.

[99] See Government of Ontario Press Release issued October 16, 2001, announcing the passage of the ECA.

Commenters noted that, except for National Policy 11-201 and National Policy 47-201, neither the CSA nor the Commission has offered guidance with respect to how securities can be offered over the Internet under existing Canadian securities laws. However, they did not provide specific examples of areas in which guidance is required. Market actors should start from the premise that the Act in no way prohibits Internet offerings and that the requirements that apply to paper-based offerings continue to apply to online offerings. The CSA has provided some guidance in NP 47-201 but has made it clear that this policy guidance does not change any substantive requirements of securities legislation.[100] Accordingly, the Committee is of the view that additional regulation governing the sale or offering of securities on the Internet is unnecessary.

As pure DPOs are conducted without the involvement of an underwriter, issuers must find another way to comply with the requirement for trades in securities to be made through a registered dealer.[101] The DPOs that have been completed to date have been done by having the issuer itself register as a "security issuer" (defined as "an issuer that is registered for trading in securities for the purpose of distributing securities of its own issue solely for its own account").

Some argue that requiring an issuer to register under the security issuer category is cumbersome and impedes an issuer's ability to quickly complete an offering of securities on the Internet. These commenters believe that eliminating the security issuer requirement would be desirable from the standpoint of the issuer because it enables the issuer to go to market more quickly.

However, eliminating the security issuer registration requirement would leave important investor protection issues unaddressed.[102] The Committee does not believe there is anything about an Internet offering that eliminates the public policy rationale for the registration requirement. Without the appropriate know-your-client and suitability checks in place, investors may purchase securities that are highly speculative and inappropriate for the investor given his or her personal circumstances, investment experience, investment objectives and financial means. Furthermore, in a disintermediated market, it is unclear to us who would assume responsibility for various functions which dealers would normally perform in a conventional offering (i.e., clearance and settlement; custody, valuation and reporting; research and analysis).[103]

In the Committee's view, if suitability and know-your-client assessments are necessary and appropriate protections in the context of offerings which are not conducted over the Internet, we see no reason why they should be unnecessary in the context of Internet offerings.

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[100] See "Responses to Comments" in National Policy 47-201 (1999), 22 OSCB or online at: osc.gov.on.ca/en/Regulation/Rulemaking/Policies/47-201_19991217.html.

[101] The Act, s. 25.

[102] See Comment Letter of the IDA.

[103] See Comment Letter of Osler, Hoskin & Harcourt LLP.

Recommendation:

In light of investor protection concerns, the Committee is of the view that it would not be prudent to eliminate the need for registrant involvement in Internet offerings.

7.5 Methods of Delivery

When an issuer is required to deliver documents to its shareholders, the Act does not specify the method of delivery except in a take-over bid context where delivery "by pre-paid mail" is contemplated. The CSA has offered guidance through National Policy 11-201 for issuers who wish to deliver these documents electronically. If an issuer satisfies four criteria set out in the Policy then, for documents where the method of delivery is not specified in the Act, an issuer may deliver them electronically.[104] The Committee agrees with this approach, as it offers flexibility to issuers who wish to avail themselves of the benefits of electronic delivery, but only permits them to do so where the recipient actively chooses electronic delivery.

7.6 Access-Equals-Delivery

In May 2000, the SEC issued a Release in which it sought comment on whether the delivery model presently contained in U.S. securities legislation should be replaced with an "access-equals-delivery" model.[105] Under such a model, investors would be assumed to have access to the Internet, thereby allowing delivery to be accomplished solely by an issuer posting a document on the issuer's or a third party's website. In the Release, the SEC stated that:

> We believe that the time for an 'access-equals-delivery' model has not arrived yet. Internet access is more prevalent than in 1995, but many people in this country still do not enjoy the benefits of ready access to electronic media. Moreover, even investors who are online are unlikely to rely on the Internet as their sole means of obtaining information from issuers or intermediaries with delivery obligations. Some investors decline electronic delivery because they do not wish to review a large document on their computer screens. Others decline electronic delivery because of the time that it takes to download and print a document.[106]

The comments received by the SEC did not persuade it to abandon the present system of document delivery.

National Policy 11-201 states that "referring an intended recipient to a third party website will generally not constitute valid delivery unless the recipient had previously consented to this form of delivery."[107] Thus, the CSA would permit an issuer and shareholder to agree between themselves that delivery obligations can be satisfied by reference to the third party website. However, the Policy does not, and could not, shift the onus of ensuring that shareholders receive disclosure documents from issuer to investor.

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[104] The four components of electronic delivery of documents are:

1. The recipient of the document receives notice that the document has been, or will be, sent electronically or otherwise electronically made available, as described in section 2.2.
2. The recipient of the document has easy access to the document, as described in section 2.2.
3. The deliverer of the document has evidence that the document has been delivered or otherwise made available to the recipient, as described in section 2.4.
4. The document that is received by the recipient is not different from the document delivered or made available by the deliverer, as described in section 2.6.

[105] "SEC Interpretation: Use of Electronic Media," Release Nos. 33-7856, 34-42728, IC-24426; File No. S7-11-00 (May, 2000).

[106] *Ibid.*

[107] This statement appeared in the "Responses to Comments," which were attached to the final version of NP 11-201. The actual provision in the Policy is as follows: "An attempt to deliver documents by referring an intended recipient to a third party provider of the document, such as SEDAR, will not likely constitute valid delivery of the document, in the absence of consent given by the intended recipient to such method of delivery."

The delivery requirements in the Act must be re-evaluated in light of the Internet. The Commission, together with other members of the CSA, has responded to this imperative and we agree with the steps they have taken. The next step would be to consider whether "access-equals-delivery" is a viable model. Should investors bear the onus of retrieving materials from the issuer's website? What about investors who do not have access to the Internet, or electronic capabilities to download and print large documents containing advanced graphics? On the other hand, there is considerable anecdotal evidence that suggests many investors do not read or want all material required to be delivered to them. It is also clear that an access-equals-delivery approach would result in significant cost savings to the industry, which hopefully would be shared by investors.

As the approach to delivery evolves, one way for the CSA to phase in electronic delivery would be to consider whether different delivery obligations should apply to different categories of documents. For example, those documents that convey information but do not require any action by the shareholder (e.g., issuer's financial statements) might be considered appropriate candidates for an access-equals-delivery approach. On the other hand, documents that invite shareholders to take some form of specific action in connection with a particular corporate event (e.g., a take-over bid circular or a proxy circular) would require actual delivery.

Recommendations:

1. **The CSA should begin to consider alternative models for delivery of documents, whether the implementation of an alternative delivery model is feasible, the substantive rules that would underpin an alternative delivery model and how the model could be implemented.**

2. **In considering the implementation of an alternative model for delivery of documents, the CSA should consider distinguishing between disclosure documents that contain corporate information but do not require any immediate action by a shareholder (such as financial statements) and disclosure documents that require shareholders to take some form of specific action in connection with a particular corporate transaction (such as a take-over bid circular). Such an alternative communication model might introduce the "access-equals-delivery" approach only with respect to documents that do not require the shareholder to take any specific action.**

PART 3
REGULATION OF MARKET PARTICIPANTS

In carrying out its mandate to protect investors and foster fair and efficient capital markets, the Commission regulates individuals and companies who give advice or trade in securities. The regulatory regime also makes use of SROs that exercise some direct oversight and responsibility for their respective areas of competence. SROs are in turn subject to oversight by the Commission. SROs can be a valuable complement to the Commission in achieving the objectives of regulation. In this part, we examine the role and regulation of key market participants including registrants, SROs and clearing agencies.

Chapter 8: Registration

8.1 Registration

The requirement for dealers and advisers to be registered is one of the fundamental concepts in securities regulation. Registration allows the Commission to impose proficiency and capital requirements on those who play these key roles in the capital markets and to impose and enforce certain standards of conduct. The Act provides that no person may "trade" in a security without being registered and that no person may act as an "adviser" without being registered.[108]

The Committee has focussed on two issues in particular in reviewing the registration provisions in the Act. The first relates to the overly broad net cast by the requirement to be registered to effect a "trade" in a security. The second is the convergence between trading and advising activity. Businesses and individuals who have been registered to effect trades in securities as dealers and employees of dealers are providing more and more financial advice to their clients before executing a trade. However, the proficiency requirements for dealers and their employees are unchanged and are based on the dealer and its employees primarily providing trade execution services and not financial advice.

8.2 Should the Requirement to Be Registered to "Trade" in Securities Be Modified?

The definition of a "trade" is very broad.[109] It includes any act "in furtherance of a trade." The Act provides a number of exemptions from the registration requirement for trades where investor protection considerations do not require the involvement of a registrant.[110]

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[108] The Act, subsection 25.1(1).

[109] "Trade" or "trading" includes,

(a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith,

(b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system,

(c) any receipt by a registrant of an order to buy or sell a security,

(d) any transfer, pledge or encumbrancing of securities of an issuer from the holdings of any person or company or combination of persons or companies described in clause (c) of the definition of "distribution" for the purpose of giving collateral for a debt made in good faith, and

(e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing. (The Act, subsection 1(1)).

The Committee considered whether the registration requirement in the Act should be amended to require persons or companies who are "in the business of trading in securities", rather than persons who "trade" in a security,[111] to be registered. This would lessen the need for discretionary exemptions from the registration requirement for particular "trades", but investor protection concerns would continue to be addressed since registration would be required for those actively involved in the business of trading in securities.

There may be some concern that changing the registration requirement to "in the business of" trading would introduce uncertainty into the marketplace. There has been little, if any, administrative or judicial consideration of what "in the business of" means in the securities context. Given that registration to trade is a precondition to a person or company being able to trade in securities, there may be concerns about introducing a change in the fundamental test for registration to one which contains elements of subjectivity. The current test is clear: any trade in securities must be effected by a registrant unless there is an exemption.

There is considerable precedent for regulation only to the extent that activities are carried on by persons "in the business of" that activity. For example, the adviser requirement is not triggered each time a person gives advice on investing in, buying or selling a security. Instead, the person must be "engaging in, or holding himself, herself or itself out as engaging in, the business of advising others as to the investing in or buying or selling of securities". Consequently, there has been little reason for exemptions to the adviser registration requirement; the number of exemptions from the adviser registration requirement is, in fact, quite limited. Similarly, the definition of "market intermediary",[112] which is the underpinning of the universal registration regime in Ontario, is based on the concept of being "in the business of" trading in securities. Thus, currently in Ontario both advisers and market intermediaries only need to register if they are "in the business".

The Committee considered the registration requirements in other provinces of Canada. Each province, other than Quebec, has a registration model for dealers similar to that in Ontario, whereby the trade registration requirement is based on trade activities rather than being in the business of trading. In Quebec, section 148 of the Quebec Act reads "no dealer or adviser may carry on business unless he or she is registered as such with the Commission".[113]

The Committee also considered on a comparative basis the registration requirements in the United States, Australia, Hong Kong and the United Kingdom. In the United States, Australia and Hong Kong the requirement to be registered as a dealer is triggered based on a person or organization being "in the business of" either effecting transactions or buying and selling securities (United States) or dealing in securities (Australia and Hong Kong). In addition, these three jurisdictions have separate registration requirements for advisers.[114] Similarly, the requirements to be registered as an adviser in these jurisdictions require the person or organization to be engaged in the business of advisory activities as they are defined under the legislation. The United Kingdom has very recently moved to a registration requirement for anyone who is in the "investment business," which is defined as the business of being engaged in an activity listed on a Schedule to the Act, and includes both trading activities and advising activities.

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[110] See, for example, the exemption provided at subparagraph 35(1)(12)(iii) of the Act, which is required in order to permit the exercise of conversion rights attached to convertible securities; the exemption provided at paragraph 35(1)(17) of the Act, which allows a holder to tender securities to a take-over bid; or the exemption provided at paragraph 35(1)(19) of the Act, which permits a company to issue stock options to its employees.

[111] See comment letter of Osler, Hoskin & Harcourt LLP.

[112] Section 204 of the Regulation.

[113] Quebec *Securities Act*, R.S.Q., c.V-1.1, s. 148.

[114] Proposed amendments to Australian legislation will, however, move to a model of one registration requirement regardless of whether the activity is dealing or advising.

Our primary consideration in reviewing whether the registration requirement for trading should be changed to an "in the business of" trigger is that there should be one consistent and intelligible scheme for registration across Canada. Business is frequently conducted in more than one province, and we would not advocate a model which further fragments the registration requirements across the country. We also seek to harmonize the registration requirements with other countries, if that is possible.

We believe there is significant merit in moving to a requirement to be registered only for persons or companies which are "in the business of" trading in securities. Moving to a registration requirement based on being in the business of trading would simplify the Act by removing the need for it to contain numerous exemptions for particular types of "trades." It is a model that is already familiar because of the adviser and market intermediary registration requirements. It is a model that will be harmonized with the approach in other countries (United States, Australia, Hong Kong and the United Kingdom). However, it will be a marked departure from the scheme in all other provinces except Quebec. Therefore, we do not support adopting this model unless it is adopted across the country by the CSA. In matters of registration, national harmonization is ultimately more important than global harmonization.

Recommendation:

We recommend that the registration requirement relating to trading should be moved to a model requiring the person or company to be "in the business" of trading. However, we would only support such a change if it were to be adopted across the country.

8.3 Does the Requirement to Be Registered to "Trade" in a Security Properly Capture the Range of Activities in Which Intermediaries Engage?

(a) Changes in Types of Services Provided

The nature of the services intermediaries provide to their clients, particularly their retail clients, has evolved since the registration provisions in the Act were developed. The following are some of the most significant developments in recent years:

- *Dealers Providing Advice Beyond What Is "Incidental"* – The trading environment has changed significantly as a result of discount dealers who provide no investment advice and charge a much reduced per transaction fee for trade execution services only. In an effort to distinguish themselves from discount dealers, full service dealers have developed delivery models and fee structures that focus on the advisory services they provide in contrast to the trade execution services provided by discount dealers. Historically, there has been no reason for registered dealers to register as advisers to carry out trade activities accompanied by incidental advisory services. In this business model, the advice they are providing falls within the exemption for adviser registration available when the provision of advice is "solely incidental to their principal business or occupation."[115] A dealer will generally rely on this exemption where it is compensated through trading commissions and is not compensated separately for providing advice. Today, however, when dealers are offering more advice along with their trading services, and are seeking to be compensated by a fee structure rather than trading commission, it is more difficult for them to rely upon this exemption.

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[115] The Act, clause 34(c).

- *Financial Planners* – Financial planners are becoming increasingly prevalent in the Canadian marketplace. Financial planners frequently are licensed mutual funds salespersons dually licensed to sell life insurance. In addition to selling these products, they will advise a client on other financial matters including mortgages, car loans, wills, allocation of investments among asset classes, and credit cards. As the range of matters on which they advise exceeds the ambit of the Act, securities regulators have been struggling to find an effective model for regulating financial planners.
- *Internet* – The Internet also raises serious issues for registration. Numerous websites offer advice and recommendations concerning securities. To the extent no fees are paid for this advice, it is arguable that persons operating the websites are not "in the business of" advising others and therefore are not caught by the current definition of "adviser."

(b) Ancillary Advisory Activities

As a consequence of these changes in market practice and the increased blending of trading and advising activities in some services offered by dealers (i.e., "wrap accounts"), the Committee considered whether the requirement to be registered to trade in securities should be re-focussed to address advisory functions as well as trade execution services.

As a preliminary matter, we note that any expansion we recommend of the registration requirements applicable to those trading in securities to encompass their expanded advisory activities is not intended to replace the current adviser registration requirements. Advisers registered as investment counsellors and portfolio managers under the Act are subject to some of the most stringent registration requirements of the Act. This is because registration as a portfolio manager permits a person to manage other people's money on a fully discretionary basis. The competency and experience of advisers must be commensurate with these responsibilities. We believe the current proficiency and experience requirements for advisers who are managing portfolio investments are appropriate and should be maintained.

Instead, we believe that the current registration requirements applicable to dealers should be examined carefully by the Commission and the CSA with a view to ensuring that the applicable regulatory requirements match the expanded role that has developed for "ancillary advising." We do not believe that dealers and their employees should be prohibited from expanding the services offered to their clients, but the proficiency, experience, suitability and other regulatory requirements which currently apply to brokers must be flexible enough to adapt to these marketplace shifts.

Recommendation:

The current requirements in the Act to be registered either as an adviser or to trade in a security should be retained. However, the Commission and CSA should carefully review the proficiency, experience and suitability requirements applicable to dealers and employees to ensure that they are sufficiently rigorous to match the increasingly important role of "ancillary advice" delivered by dealers and their employees.

(c) Trade Execution Only Services

On the other hand, some dealers (or business units) have moved to eliminate all ancillary advisory services and to offer trade execution services only. We examined whether there are activities or transactions that should be exempt from the need to involve a regulated entity. We also considered whether the traditional obligations of registrants, such as assessments of suitability and "know-your-client" obligations, need to be examined in an electronic trading environment.

Commenters to the Committee on this topic indicated that, if investors feel capable of making an investment decision and knowingly choose to make their decision without any recommendation, advice or suitability analysis from a registrant, there are no investor protection issues that require regulators to prohibit investors trading without the benefit of all the services provided by a registrant. Such investors will have waived their right to an important basis of recourse in the event of a dispute concerning a trade, because most such disputes centre on the suitability of the trade. It is critical that investors understand they are waiving this remedy when they waive the know-your-client and suitability protections.

The CSA has announced that relief from the suitability and know-your-client obligations will be granted on an application basis to dealers who offer only trade execution services to their clients,[116] and the IDA has amended its regulation to provide that all IDA member dealers will no longer have to conduct know-your-client and suitability analyses in cases where the client is not provided with a recommendation on a particular transaction.[117] The Committee supports the current position of the regulators and the IDA which exempts those who offer only trade execution services from the know-your-client and suitability requirements.

(d) Financial Planning Activities

With respect to the advising activities undertaken by financial planners, the Committee understands the concerns of the Commission and the CSA that persons who are registered in a restricted category of dealer are adopting titles which appear to convey a degree of experience and expertise which may be misleading to the public. We note that the CSA has enacted MI 33-107 "Proficiency Requirements for Registrants Holding Themselves Out as Providing Financial Planning and Similar Advice" which was scheduled to come into effect on February 15, 2002.[118] In Ontario, the Minister returned the Instrument to the Commission for further consideration. The Instrument would impose proficiency requirements on any registrant adopting a title that conveys that financial planning or similar objective, comprehensive, integrated personal financial advice is offered.[119] While the Instrument has not been without controversy, we support what the CSA is trying to achieve through this initiative and the proposition that registrants who wish to be in business to trade in securities and offer ancillary advice in connection with that business must be proficient and qualified to do so.

(e) Financial Portals

"Financial portals" are websites that provide financial and market information and advice concerning investment in securities. The content on these websites typically includes information such as news on industry sectors and trends, company and fund research, earnings estimates, price and news alerts, research reports and lists of stocks that portfolio managers are purchasing. Many financial portals have online discussion forums relating to particular stocks and industries. Some provide model portfolios with specific stock recommendations.

The Committee believes that portals may be engaging in registrable activities depending upon the nature of the portal, the information provided, the role played by the portal "sponsor" and other fact-specific considerations. The Commission, as the principal regulator under the MRRS, recently considered these issues in the CanIssue decision.[120] This application dealt with a company which was established as a vehicle through which certain dealers will make information regarding corporate debt issues available to institutional investors on a website. The company is owned by the dealers but will not make profits or distributions to shareholders. The company is being used as a mechanism to allow the dealers to share the expense of operating the website. In its decision, the Commission provided an exemption from registration to the company under specific conditions, including the requirement that the dealers participating in the system would be registered as dealers in their respective jurisdictions. We endorse the flexibility inherent in this approach and encourage the Commission to continue to facilitate the use of financial portals when appropriate.

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[116] "CSA Provides Relief from Suitability Obligations," CSA news release, April 10, 2000 ((2000), 23 OSCB 2683).

[117] (2001), 24 OSCB 2923 and 4513.

[118] (2001), 24 OSCB 1107.

[119] *Ibid.*

[120] *In the Matter of CanIssue Inc.* (2001), 24 OSCB 4533.

At the same time we encourage the Commission, together with the CSA, to continue to monitor the use of financial portals by market participants. We believe that enforcement proceedings are an appropriate regulatory tool to address inappropriate conduct by persons involved in these Internet activities.[121] Our recommendation in Chapter 22 to expand the Act's enforcement mechanisms by creating an offence of fraud and market manipulation will enhance the Commission's ability to regulate these activities by enforcement rather than by imposing a new registration requirement.

Recommendation:

The Committee encourages the Commission, together with the CSA, to continue to monitor the use of financial portals by market participants, and to facilitate their development where appropriate. Where portals conduct activity in violation of the requirements of the Act, we believe the regulators should bring enforcement proceedings.

8.4 Universal Registration

The Committee considered whether the concept of universal registration should be eliminated. As noted above, the Act requires any person or company trading in a security to be registered as a dealer, and anyone in the business of advising to be registered as an adviser. The Act also contains exemptions from these registration requirements. In all provinces, and in Ontario and Newfoundland prior to 1987, prospectus and dealer registration exemptions of applicable securities legislation tend to operate in tandem; that is, if there is an exemption from the requirement to prepare a prospectus, there is also an exemption from the requirement to effect the trade in the security through a registrant. The premise underlying these exemptions is that there are certain types of securities, trades and purchasers for which and for whom the protections of the Act, as embodied in the prospectus and registration requirements, are not necessary.

In 1987, however, Ontario introduced a system of universal registration, which was subsequently adopted by Newfoundland but has not been adopted by any other province. The result of the introduction of universal registration was to remove from "market intermediaries" the ability to trade in securities in reliance on the exemptions in the Act.[122] The result of the introduction of universal registration was, in effect, to impose an obligation to be registered in some category on every trading participant in the

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[121] On February 26, 2002, the Commission issued temporary cease-trade orders against Create-a-fund Incorporated, alleging it offers websites which purport to offer investment services such as portfolio customizing and investment monitoring for which registration is required.

[122] A "market intermediary" is defined in s. 204 of the Regulation as: a person or company that engages or holds himself, herself or itself out as engaging in Ontario in the business of trading in securities as principal or agent, other than trading in securities purchased by the person or company for his, her or its own account for investment only and not with a view to resale or distribution, and, without limiting the generality of the foregoing, includes a person or company that engages or holds himself, herself or itself out as engaging in the business of,

(a) entering into agreements or arrangements with underwriters or issuers, in connection with distributions of securities, to purchase or sell such securities,

(b) participating in distributions of securities as a selling group member,

(c) making a market in securities, or

(d) trading in securities with accounts fully managed by the person or company as agent or trustee,whether or not the person or company engages in trading in securities purchased for investment only.

Ontario markets that fell within the definition of "market intermediary."

Dealers which, prior to the adoption of the universal registration regime, were not required to be registered to deal in exempt securities now must be registered. We note that most are registered in the category of limited market dealer. The category is often criticized because it contains no capital adequacy or reporting requirements; registration is generally granted on the basis of an application and payment of the requisite fee. Universal registration is also cumbersome and unique to Ontario and Newfoundland.

Commenters to the Committee have divergent views as to whether the system of universal registration should be eliminated.[123] The arguments in favour of abolishing universal registration are that it inhibits regulatory harmonization and that it is complicated. The arguments in favour of maintaining universal registration are based on the need for a level playing field and upon the presumption that investor protection is augmented and solvency risk reduced by regulating participants in the market. However, the limited market dealer category currently appears to be relatively ineffective in achieving these goals.

Even if the registration model is not amended as we propose, we believe that the universal registration requirements should be eliminated from the Act because they do not bring any real investor protection or address any matters of systemic risk. Further, they are out of step with regulation in the rest of the country.

Recommendation:

We recommend the Act be amended to eliminate the universal registration requirements.

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[123] See comment letters of the Canadian Bankers Association, the Investment Council Association of Canada, FSCO, Simon Romano, Nancy Ross and the IDA.

Chapter 9: Self-Regulation

9.1 Overview

Part VIII of the Act is entitled "Self-Regulation." Part VIII deals not only with SROs, but also stock exchanges,[124] clearing agencies[125] and quotation and trade reporting systems.[126] Part VIII permits the Commission to "recognize" the market participants referred to above. Currently, however, only stock exchanges must be recognized in order to carry on business in Ontario.[127] When an organization is "recognized" by the Commission, it may continue to 'regulate the operations and standards of practice and business conduct" of its members,[128] but is subject to the exercise by the Commission of its oversight function.[129] Once an organization is recognized, the Commission has the authority to review any of the organization's directions, decisions, orders or rulings.[130]

When an entity is "recognized" by the Commission, it becomes a "market participant." Among other things, this makes the entity subject to provisions of the Act other than Part VIII such as financial examination orders (section 13), the power of an investigating examiner (section 13), compliance review (section 20), public interest orders (section 127) and applications to court (section 128).

9.2 Should SROs Be Required to Be Recognized?

An SRO is "a person or company that represents registrants and is organized for the purpose of regulating the operations and the standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest."[131] SROs may apply for recognition, but they are not obliged to be recognized. The Commission has recognized only the IDA, the MFDA and RS Inc.[132] as SROs. Every securities dealer, investment dealer, and broker is required to be a member of a recognized SRO (currently, the IDA).[133] Every mutual fund dealer is required to be a member of the MFDA.[134] Every ATS is required to retain a regulation services provider to set and enforce requirements governing the ATS and its subscribers.[135]

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[124] The Act, subsection 21(1). Subsection 1(1) of the Act defines "recognized stock exchange" as "a person or company recognized by the Commission under section 21."

[125] The Act, subsection 21.2(1). Subsection 1(1) of the Act defines "clearing agency" as "a person or company that acts as an intermediary in paying funds or delivering securities, or both, in connection with trades in securities and that provides centralized facilities for the clearing of trades in securities."

[126] The Act, subsection 21.2.1(1). Subsection 1(1) of the Act defines quotation and trade reporting system as "a person or company that operates facilities that permit the dissemination of price quotations for the purchase and sale of securities and reports of completed transactions in securities for the exclusive use of registered dealers but does not include a stock exchange or a registered dealer."

[127] The Act, subsections 21(1), 21.2(1), 21.2.1(1).

[128] The Act, subsection 21.1(1)(3).

[129] The Act, subsection 21.1(1)(4).

[130] The Act, s. 21.7

[131] The Act, s. 1.1.

[132] RS Inc. was recognized by the Commission on January 29, 2002 ((2002), 25 OSCB 891). RS Inc. operates as a regulation services provider under the Alternative Trading System rules and administers and enforces trading rules for the marketplaces that retain its services.

[133] See OSC Rule 31-507 SRO Membership – Securities Dealers and Brokers.

[134] See OSC Rule 31-506 SRO Membership – Mutual Fund Dealers.

Under the Act, it is possible for an organization whose purpose is to regulate the operations and standards of practice of its members to establish itself as an SRO without being recognized. In fact, the IDA acted for decades as an SRO until it was formally recognized by the Commission in 1995. The Committee believes that organizations that want to represent registrants, for example for lobbying purposes, should be able to do so without being subject to regulatory oversight. However, to the extent an organization wishes to go further and regulate "the operations and the standards of practice and business conduct of its members" (which would make it an SRO), we believe it should have to be recognized and subject to Commission oversight.

Recommendation:

The Act should be amended to require that SROs, as defined by the Act, must be recognized to carry on this function in Ontario.

9.3. Should Recognition Be Required for Clearing Agencies?

In addition to regulating stock exchanges and SROs, Part VIII deals with clearing agencies. Clearing agencies may carry on business without being recognized by the Commission.[136] The Canadian Depository for Securities is recognized as a clearing agency, but FundSERV is not. Both carry on business as clearing agencies.

The Committee considered the important role that clearing agencies perform in securities transfers. Prompt and accurate clearance and settlement of securities transactions is necessary to enhance the efficiency of the capital markets and to protect investors. In addition, inefficient procedures for clearance and settlement impose unnecessary costs on investors and create systemic risk.[137]

In light of the important role played by clearing agencies in establishing confidence in the capital markets,[138] the Committee believes that they should be required to obtain recognition. Requiring all agencies that carry on a clearing and settlement business in Ontario to be recognized subjects them to regulatory oversight and provides regulators with the necessary tools to impose minimum standards on those that perform this critical role. Finally, requiring clearing agencies to obtain recognition is in the public interest not only in terms of protecting investors and enhancing the efficiency of capital markets, but also in terms of safeguarding securities and maintaining fair competition.[139]

Recommendation:

We recommend that clearing agencies should be required to obtain recognition. We recommend amending section 21.2 of the Act to provide that "No person or company shall carry on business as a clearing agency unless recognized by the Commission."

9.4. Should Recognition Be Required for QATRS?

The Committee also considered whether a person should be required to be recognized to carry on business as a QATRS. A "quotation and trading reporting system" is defined in the Act as a "person or company that operates facilities that permit the dissemination of price quotations for the purchase and sale of securities and reports of completed transactions in securities for the exclusive use of registered dealers."

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[135] See National Instrument 23-101 Trading Rules. An exchange or quotation and trade reporting system has the option of monitoring the conduct of its members or users and enforcing the requirements set either directly or indirectly through a regulation services provider.

[136] The Act, s. 21.2.

[137] See the 1934 Act, subclauses 17A(b)(1), 17A(a)(1).

[138] IOSCO, Report of the Technical Committee, *Objectives and Principles of Securities Regulation* (1998), http://www.iosco.org/docs-public/1998objectivesdocument03.html.

[139] See the 1934 Act, subclause 17(A)(a)(2)(A).

We question whether this definition is broad enough. It was developed when CDN was operating and was, we understand, intended to describe all of the activities in which CDN was engaged. Although this includes over-the-counter trading, it is not apparent from the definition of QATRS that this activity is included. We urge the Commission to consider this issue together with the relationship between QATRS and the unlisted market discussed below. We believe that it is important for QATRS to maintain high standards in their operations and that the proper functioning of these entities is fundamental to investor confidence. NI 21-101 Marketplace Operation (the "ATS Rule") currently contains recognition requirements for quotation and trade systems, but there is no specific requirement that a QATR be recognized. We ask that the Commission consider whether QATRS should be required to obtain recognition. We also urge the Commission to work with other Canadian jurisdictions to develop a harmonized approach to QATRS.

9.5 The Unlisted Market

As part of the reorganization of Canada's stock exchanges, CDN ceased operations on quoted and unquoted securities. All CDN quoted securities moved to TSX Venture and all unquoted securities moved to the new CUB. CUB issuers are not required to meet any listing requirements, maintain any liquidity or provide any regulated disclosure to investors. We believe that the activities of the unlisted market merit regulatory review to determine whether recognition of this market, with its attendant regulatory oversight, is appropriate.

Recommendation:

We recommend that the Commission and the CSA consider whether to require QATRS and the unlisted market to obtain recognition under securities legislation and to develop a harmonized approach to QATRS and the unlisted market.

9.6 Enforcing Their Own Rules

In our Issues List we asked whether recognized SROs and exchanges should have legislated enforcement powers with respect to their own rules. We asked this question because we are aware of a perception that it is sometimes difficult for these organizations to impose meaningful sanctions on their members. Further, the 1934 Act explicitly permits an SRO to suspend or revoke a member's registration, to censure or impose limitations on the member, or to remove from office or censure any officer or director of a member if doing so would be in the public interest.[140]

In response, the IDA stated that: "SROs currently derive their authority from a contractual relationship with their members. We believe that this current relationship has worked satisfactorily and see no compelling reason to change it by legislating that relationship."

TSX Venture stated that it would "encourage the adoption of legislation and rules which would improve the enforcement abilities of SROs, such as a subpoena power."

Recognized SROs and exchanges have the ability to establish codes of behaviour and practice, and establish sanctions for breach of these rules, both through contractual agreements with their members and through their by-laws. While we do not believe that the Act needs to be amended to provide SROs and exchanges with powers to do that which they can do contractually and corporately, there may be a need to give SROs authority to conduct investigations and obtain evidence from non-members. We invite further comment on this point.

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[140] 1934 Act, s. 19.

9.7 Enforcing Compliance with Securities Laws

In the United States, SROs are required to enforce the 1934 Act.[141] The Committee considered whether recognized SROs should have the explicit authority and obligation to enforce Ontario securities law. Section 21.6 of the Act states that no by-law, rule, regulation, policy, procedure, interpretation or practice of a recognized entity may contravene Ontario securities law, although the recognized SRO may impose more stringent requirements. As a result of this provision, SRO rules often build upon existing securities law. The recognized entity thus indirectly enforces Ontario securities law when it enforces SRO rules.

There would be certain efficiencies to be gained from involving SROs in compliance. SROs already perform a monitoring function in respect of their members, including monitoring to ensure compliance with the SRO's own rules and regulations.

The IDA opposes requiring SROs to enforce securities law. It contends that this would result in confusion as to these roles and could further result in "double jeopardy" for registrants.[142] TSX Venture echoed this view, stating: "it is not appropriate to delegate responsibility for enforcement of securities legislation to SROs… . SROs, not being government bodies, have different burdens of proof, different evidentiary standards and different procedures than do securities Commissions." TSX Venture stated that the roles of securities commissions and SROs should be kept distinct.

The Committee concluded that SROs should not be required to enforce Ontario securities law for the reasons articulated by the IDA and TSX Venture. However, the Committee believes that SROs should be required to report immediately to the Commission any activity which appears to the SRO to contravene Ontario securities law. This would prevent SROs from turning a blind eye to breaches or possible breaches of the Act. In our view, this requirement should be contained in the terms and conditions of the SRO's recognition.

Recommendation:

We recommend that SROs be required to report to the Commission any breaches or possible breaches of securities law that they believe have occurred or may have occurred.

9.8 The Separation of Self-Interest and Self-Regulation

A pressing issue surrounding the self-regulatory regime in Ontario is the potential conflict of interest between the regulatory/public interest role of an SRO and its commercial objectives. For example, in Canada, the IDA is both an SRO and a trade association for investment dealers. As an SRO, the IDA regulates the capital adequacy and business conduct of investment dealers and takes enforcement action against member firms and individual salespeople for breaches of the IDA rules. It also assists regulatory authorities in developing policies designed to achieve investor protection and market efficiency.[143] As a trade association, the IDA represents the interests of member firms to federal and provincial governments and their agencies in areas such as financial institution legislation, securities regulation, and fiscal and monetary policy.[144] The IDA fulfils an advocacy function on behalf of its members and seeks "to achieve more narrow commercial objectives on the part of our members, with less focus on the broader public interest."[145]

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[141] 1934 Act, s. 6.

[142] Comment Letter of the IDA.

[143] *Ibid.* at page 9.

[144] This information was retrieved from the IDA's website on July 28, 2000, at www.ida.ca. The IDA makes a similar point in its Comment Letter to the Committee.

[145] Comment Letter of the IDA, at page 10.

The dual role of SROs presents a potential for conflict. Trade associations advocate on behalf of their members in lobbying governments, but as a regulator, each SRO sets requirements that govern the conduct of its members. The SRO is responsible for disciplining those who have breached the requirements. The concern is whether the SRO will set standards of conduct to protect the investing public as high as an arm's length organization might, when such standards may represent compliance challenges to its members. In addition, will the organization be forceful in pursuing violations of such standards and in meting out appropriate sanctions against its members?

In its Comment Letter, the IDA stated that it believes that "there is no meaningful conflict, beyond the conflict inherent in self-regulation, that should concern the regulators or investors."[146] Yet it recognizes that there may be an appearance of conflict and states that, as a result, a degree of "organizational distinctiveness" should be made clear with identifiable nomenclature and fire walls where appropriate.[147]

However, the Committee believes that conflict, including the appearance of conflict, must be contained and that the most appropriate way to do this is to separate the IDA's functions as an SRO from its role as a trade association. We are not convinced that maintaining barriers within the same organization will ensure that conflict is contained.

It is increasingly rare to find, whether in Canada, the United Kingdom or the United States, one entity carrying out the dual role described above. For instance, the TSX is subject to possible conflicts because it is owned by member shareholders and is also the market regulator. When the TSX demutualized in 2000, it established a separate subsidiary, RS Inc., which is specifically mandated to oversee member regulation. Under its terms of recognition, RS Inc. must be operated on a "cost-recovery basis and shall be independent and structurally separated from the for-profit operations of the TSX."[148]

RS Inc. is organized in this way so as to ensure that member regulation is not a for-profit activity and that trading operations do not subsidize regulation. In addition, RS Inc. has a separate committee which reports to the TSX board and over half of its directors cannot be associated with any participating organization. RS Inc. has a segregated budget which is subject to the approval of its board. In granting the TSX recognition on these terms, the Commission was of the view that this organizational structure addressed the potential for conflict between member advocacy and market regulation at the TSX.

On December 1, 2001, in the United Kingdom, the FSA became the single regulator of financial services, banking and insurance. It assumed responsibility for supervising firms formerly regulated by SROs. There is no reliance upon SROs under the new U.K. Act. We understand that one of the reasons for abandoning self-regulation is that SROs were viewed as associations that represented their members' interests over those of the investing public.

In the United States there is a clear distinction between the SRO, the NASD, and the lobby organization, the Securities Industry Association. For the reasons discussed above, we believe it is important to create the same distinction between the regulatory function and the lobby association in Canada.

Recommendation:

The Committee recognizes that there is considerable potential for conflict between an SRO's role as a trade association and its responsibilities as an SRO. Ideally, we believe that trade association and SRO functions should be carried out by two separate bodies, each with distinct governance structures. In

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[146] *Ibid.*

[147] *Ibid.*

[148] TSX Recognition Order, April 3, 2000 (2000), 23 OSCB 2495.

this regard, the body charged with the SRO role should ensure that at least 50 per cent of its directors are independent from its members. We support the model adopted by the Securities Industry Association and the NASD in the United States.

9.9 Commission Oversight

The Committee considered whether changes to the Act are required to address the SRO regulatory oversight function and provide the Commission with the tools necessary to perform its oversight function effectively. The oversight powers in the Act are comprehensive and include the power of the Commission to review and approve by-laws, to hear appeals of decisions of an SRO and to request that an SRO retain an auditor to conduct compliance reviews. In addition, SROs themselves perform annual reviews of their compliance with their rules of conduct.

The efficacy of the oversight function depends to a significant degree on the commitment of the Commission to actively monitor and oversee the activities of SROs. Nothing has come to the Committee's attention to indicate that the oversight function of the Commission is not working properly. In its statement of priorities for the 2000-2001 fiscal year, the Commission stated that it seeks to increase its presence and effectiveness through various compliance monitoring and enforcement activities, including: strengthening protocols for SRO oversight through the development of oversight agreements and by-law protocols; performing more compliance examinations and inspections of dealers and advisers, including one national compliance review; and completing examinations of the TSX and the IDA.

The Committee therefore believes that the Act provides sufficient legislative tools to enable the Commission to perform its SRO oversight function. In addition, the Commission has increased its emphasis on the oversight function, making regulatory oversight one of its priorities. Thus, the Committee does not recommend the addition of new oversight powers.

PART 4
THE CLOSED SYSTEM AND SECONDARY MARKETS

A short time ago, Enron collapsed. Every day more details emerge about its governance, accounting and disclosure practices. In Canada, investors are still looking for answers on Bre-X, YBM Magnex, Livent and Phillips. In this Part, we discuss whether the Act imposes disclosure obligations on public companies that are adequate to ensure that investors in the secondary markets can make informed decisions and have confidence in the reliability of corporate disclosure. We also discuss the existing "closed system" and how the regulation of exempt offerings and hold periods restricts access to secondary market liquidity. We consider how the "closed system" could be simplified without undermining investor protection and capital markets efficiency.

We have made the case earlier in this report for the importance of Canadian capital markets being competitive on a global basis. Because capital formation is not constrained by national borders, it is critical that Canada be perceived, both domestically and abroad, as being a fair and safe place to invest. This in turn depends upon the emphasis we place on the integrity of our continuous disclosure system. When it comes to disclosure standards, we should strive to be "best in class".

Chapter 10: Continuous Disclosure

10.1 The Importance of Continuous Disclosure

One of the core concepts in the Act is that an issuer must provide a prospectus to prospective purchasers before it may sell securities to them.[149] The prospectus must provide full, true and plain disclosure of all "material facts"[150] relating to the securities to be issued. This allows the prospective purchaser to make an informed investment decision.

Once securities have been issued under a prospectus, they are "freely tradeable." In other words, investors may sell the securities they hold without providing a prospectus or any other information about the securities or the issuer to the purchaser. The purchaser must rely on the "public record," which consists of the prospectus and all of the information the issuer has been required to deliver to shareholders or file with the Commission pursuant to the "continuous disclosure" regime in the Act.

Secondary market trading now accounts for approximately 95 per cent of all capital markets trading in Ontario.[151] The Act does not offer the same protections to those who purchase securities in the secondary markets as it does those who purchase securities pursuant to a public offering.[152] Accordingly, in order for investors to be prepared to buy securities in the secondary market in Ontario, they must be confident that the public record will provide them with the information they need on a timely basis and that that information is reliable. This chapter discusses the current continuous disclosure regime and the Commission's role in monitoring and enforcing disclosure requirements.

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[149] The Act, subsection 53(1). More specifically, a prospectus is required if a trade is a "distribution". A "distribution" is defined in subsection 1(1) of the Act and includes "a trade in securities of an issuer that have not been previously issued." The Act provides certain exemptions to this prospectus requirement, discussed in Chapter 11 of this Report.

[150] The meaning of "material fact" is defined in subsection 1(1) of the Act.

[151] CSA Notice 53-302 Proposals for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" (2000), 23 OSCB 7383 at Section II, "Background".

10.2 The Current Regime

The Act requires reporting issuers to make certain disclosure on a regular basis throughout the year. This "periodic disclosure" is described below (in subsection 10.2(a)). Other disclosure must be made upon the occurrence of certain events. This "event-driven disclosure" is described in subsection 10.2(b) below. The theory is that the "material facts" disclosed in the prospectus, taken together with all "material changes" that have been disclosed since the date of the prospectus and all other information that forms a part of the issuer's continuous disclosure record, will keep the investing public current.

(a) Periodic Disclosure

The following is the disclosure that a reporting issuer is required to make each year.

- A reporting issuer must send quarterly financial statements (accompanied by MD&A) to its shareholders.[153]
- A reporting issuer must prepare and send to its shareholders, and file with the Commission, annual audited financial statements (accompanied by MD&A) no later than 140 days after year end.
- Most issuers are also required to file an AIF with the Commission each year.[154] The AIF provides much of the same information contained in a prospectus and in this way refreshes the narrative description of the issuer and its business on an annual basis.
- Management must send a form of proxy and management information circular to each shareholder in advance of every shareholder meeting (both annual and special). The circular must provide shareholders with information to help them make informed judgments about the matters being voted on at a meeting. The circular also must contain information about:
    - director and executive compensation;
    - indebtedness of officers and directors;
    - interests of insiders in material transactions; and
    - details relating to management contracts.

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[152] Under the existing regime, primary market investors have a statutory right to seek damages from issuers and others for losses attributable to a misrepresentation in a prospectus without having to prove reliance, which is required under existing common law rights of action. Secondary market purchasers do not have any statutory rights of actions for misrepresentations.

[153] OSC Rule 52-501 Financial Statements requires reporting issuers to include an income statement, statement of retained earnings and cash flow statement in interim financial statements for the current quarter, as well as an interim balance sheet and explanatory notes to the interim financial statements. A company's board of directors (or its audit committee) is required to review the interim financial statements before they are filed with the Commission. Companies are encouraged to consider retaining external auditors to review such statements.

OSC Rule 51-501 AIF and MD&A requires management to provide a narrative discussion and analysis (MD&A) of interim financial results together with interim financial statements.

[154] Under OSC Rule 51-501 AIF and MD&A, each reporting issuer, other than a mutual fund, is required to file an AIF if either its shareholders' equity or revenues exceeded $10,000,000 in each of the three immediately preceding financial years, or if the aggregate market value of its outstanding equity securities for which there was a published market was more than $75,000,000 on the last day of each of the three immediately preceding financial years.

(b) Event-driven Disclosure

Reporting issuers and their insiders must also disclose the following information from time to time:

- The Act requires reporting issuers to disclose "material changes" by issuing a press release describing the change (and filing a material change report with the Commission);
- Anyone who is an "insider" (typically directors, senior officers and shareholders with 10 per cent or more of the company's outstanding voting shares) must file a report within 10 days of the day on which they became an insider and after that must file a supplementary report within 10 days after they have traded their shares in the company.

10.3 Alternative Approaches to Regulation Which Emphasize the Secondary Market

We reviewed two alternative models to regulation which emphasize the secondary market.

(a) Integrated Disclosure System

In 2000, the CSA issued a concept proposal for an IDS. Under the IDS, issuers would be required to prepare and file enhanced continuous disclosure documents that would be available to all investors. Once these documents have been filed, issuers would be able to take advantage of a streamlined process for issuing securities that would consist of a "term sheet" summarizing the terms of the securities being offered and would incorporate the continuous disclosure record of the issuer by reference. This would enhance the quality and timeliness of continuous disclosure information available to investors while providing issuers with a more efficient process for clearing prospectus offerings.[155]

The primary aim of the IDS is to de-emphasize the prospectus as the issuer's cornerstone disclosure document and emphasize instead the quality of the issuer's ongoing continuous disclosure base. Under the IDS:

- investors in the secondary and exempt markets would have access to enhanced public disclosure;
- issuers could go to market more quickly with new securities issues; and
- issuers could raise capital at a reasonable cost without compromising investor protection.

We understand that the CSA is currently working on the continuous disclosure enhancements contemplated by the proposed IDS.

(b) The Company Registration Model

We also considered the company registration model proposed by the Wallman Report in the United States. Under the company registration model, companies would file a generic document similar to an AIF so that information about the issuer and its operations is on the public record. When the issuer wants to issue additional securities, only information about those securities would be required since information about the issuer itself is already on public file. Issuers would enjoy the reduced transactional costs and greater flexibility associated with a streamlined registration process.

The registration model is similar to the IDS, discussed above. We note that the SEC has not adopted the approach recommended in the Wallman Report; however, we believe there is merit to this approach and the proposed IDS and the shift in focus they represent.

10.4 How Is Continuous Disclosure Monitored and Enforced?

Until recently, there has been no regular review of the continuous disclosure practices of reporting issuers. In January 1999, the Commission created a CD Team. The CD Team reviews continuous disclosure filings made by reporting issuers, issues comment letters similar to those provided in the prospectus review process, and monitors external sources for possible disclosure deficiencies.[156] The CD Team performs two functions. First, it monitors compliance with statutory requirements, putting the Commission in a position to take action against reporting issuers who fail to comply. Second, because of the dialogue in which it engages with reporting issuers, the CD Team has begun to play an important role in helping reporting issuers understand their continuous disclosure obligations.

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[155] See CSA Notice and Request for Comment, 44-401, 51-401 Concept Proposal for an Integrated Disclosure System (2000), 23 OSCB 633.

Sanctions under the Act for failure to comply with continuous disclosure requirements are no different from those applicable to any other breach of the Act. If the CD Team deems an issuer's disclosure to be so deficient as to constitute a default, it may place the issuer on the defaulting issuer's list.[157] The CD Team may initiate a hearing before the Commission under section 127 of the Act. The Commission may require the issuer to amend its disclosure.[158]

The review conducted of an issuer's continuous disclosure record is not unlike the review that other Commission staff conducts with respect to a prospectus. However, in the prospectus context the Director has the ability to refuse a receipt for a prospectus under prescribed circumstances. The CD Team has no similar means of encouraging an issuer to respond to the issues it raises. The Act does not specifically contemplate continuous disclosure reviews (as it does prospectus reviews[159] and compliance reviews[160]). We believe that statutory recognition of continuous disclosure reviews is appropriate to emphasize the importance of continuous disclosure obligations in the current environment. In addition, civil liability for continuous disclosure (discussed below) will provide an important additional incentive for issuers, whose disclosure practices are lacking, to respond to issues raised with them by the CD Team.

Recommendation:

The Committee recommends that the Act be amended to explicitly refer to continuous disclosure reviews.

10.5 Harmonization Issues

There is no harmonized approach to continuous disclosure across Canada. For example, there are differences among the provinces and territories in the following areas:

- the definition of "material change";
- requirements relating to the preparation and filing of material change reports;
- the definition of "insider";
- requirements relating to insider reporting;
- the deadlines for filing financial statements;
- requirements relating to the filing of quarterly financial statements;
- financial statement standards;
- requirements relating to MD&A; and
- the requirement to file an AIF.

We have made our case in Part I for the importance of cross-Canada harmonization in securities regulation, including continuous disclosure. We understand that the CSA is working on harmonizing continuous disclosure requirements and we think this should be a priority.

Recommendation:

We encourage the CSA to harmonize Canadian continuous disclosure requirements and to create a base or minimum level of continuous disclosure

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[156] See OSC Staff Notice 51-703 Implementation of Reporting Issuer Continuous Disclosure Review Program (2000), 23 OSCB 4123.

[157] OSC Policy 51-601 Reporting Issuer Defaults (2001), 24 OSCB 6587, paragraph 3.3(2)4.

[158] The Act, paragraph 127(1)5.

[159] The Act, s. 61.

[160] The Act, s. 20.

requirements applicable to all reporting issuers.

10.6 Civil Liability for Secondary Market Disclosures

A discussion as to whether there should be civil liability for continuous disclosure has been underway for some time.

(a) Background

As discussed above, there are remedies available to the Commission when a reporting issuer breaches the provisions of the Act dealing with continuous disclosure. It is expected that the issuer's "directing minds" (i.e., its directors and officers) will focus most keenly on the issuer's legal obligations, when breaching those obligations could involve personal liability for them.

Over the past three decades, there have been a number of proposals to extend statutory civil liability to continuous disclosure. In 1979, the federal *Proposals for a Securities Market Law of Canada* recommended, among other things, a statutory civil liability regime covering continuous disclosure.[161] The 1979 federal proposals were not adopted. In 1984, the Commission recommended legislative amendments that would have extended statutory civil liability to continuous disclosure documents.[162]

In December 1994, the Dey Committee recommended that the issue of legislated civil liability in respect of timely and continuous disclosure should be put back on the policy agenda.[163] Shortly thereafter, the Allen Committee was appointed. It issued its report in March 1997. The Allen Committee's mandate was to review continuous disclosure by Canadian public companies and to evaluate the adequacy of such disclosure. It was also asked to consider whether additional remedies should be available, either to regulators or to investors, if issuers breach their continuous disclosure obligations.

The Allen Report concluded that there was evidence of a significant number of incidents of disclosure violations and a perception that problems exist with the adequacy of continuous disclosure in Canada. It expressed concern that these circumstances could tarnish the reputation of our capital markets with resulting loss of investor confidence. This would also have direct cost implications for Canadian companies.

Finally, in January 1999, the Mining Standards Task Force (the "Task Force") released its report entitled *Setting New Standards: Recommendations for Public Mineral Exploration and Mining Companies.*[164] It endorsed the recommendations of the Allen Committee relating to statutory civil liability for misleading continuous disclosure as a positive step towards ensuring effective accountability of companies for disclosure relating to mineral exploration, development and production.

(b) Statutory Civil Liability Regime – Draft Legislation

On November 3, 2000, the CSA published draft legislative amendments which would create a statutory civil liability regime for continuous disclosure. These Civil Liability Amendments[165] were based largely on the recommendations contained in the Allen Report. If implemented, they will give investors in the secondary market the right to sue any public company and other responsible parties for making a public material misrepresentation, written or oral, about the company or for failing to make required timely disclosure.[166] To date, the Government of Ontario has taken no action with respect to this proposed legislation.

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[161] P. Anisman, J. Howard, W. Grover & J.P. Williamson, *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, Canada, 1979).

[162] "Civil Liability for Continuous Disclosure Documents Filed under the *Securities Act* – Request for Comments" (1984), 7 OSCB 4910.

Similarly, in 1994 the B.C. government developed a proposal to introduce a limited scheme of civil liability for certain disclosure in response to the Matkin Inquiry and recommendations reflected in the Matkin Report (J.G. Matkin & G.G. Cowper, *Restructuring for the Future; Towards a Fairer Venture Capital Market*, Report of the Vancouver Stock Exchange & Securities Regulation Commission (1994)). However, by this point in time, the Allen Committee had been established and the B.C. government agreed to await the release of that committee's report with the hope that any eventual recommendations could be adopted nationally.

[163] "Where Were The Directors? Guidelines for Improved Corporate Governance in Canada", Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada (December, 1994).

[164] The Task Force was a joint task force between the Commission and the TSX.

There was considerable opposition to the Civil Liability Amendments when they were first released for comment, primarily from public companies.[167] The major concern focussed on the costs to public companies, their directors and, ultimately, their shareholders, of having to defend against unmeritorious class actions. In response to this concern, the CSA made a number of changes to the Civil Liability Amendments, including the introduction of certain procedural mechanisms designed to screen out unmeritorious actions.[168] The CSA believes that these new procedural mechanisms, together with the "loser pays" cost and proportionate liability provisions, "should ensure that any exercise of the statutory right of action occurs in a litigation environment … less conducive to coercive strike suits." A recent Ontario decision suggests that the courts will have little patience with American-style strike suits.[169] We note that, more recently, some commentators who primarily represent the plaintiff bar have in fact questioned whether the Civil Liability Amendments, if implemented, will be used by class action plaintiffs and, in such event, whether they will pose an effective deterrent.

We believe the case for statutory liability has been made and we urge the Government of Ontario to implement the proposals on a priority basis.

Recommendation:

We support the CSA proposal to create a statutory civil liability regime for continuous disclosure and urge the Government of Ontario to move forward as soon as possible to adopt such a regime by legislative amendment. We also encourage the governments of the other CSA jurisdictions to adopt the regime.

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[165] The Civil Liability Amendments are "primarily directed to providing a deterrent to misrepresentations and failures to make timely disclosure." In this regard, the Civil Liability Amendments contain liability caps which vary between different categories of defendants. For an issuer, the liability cap is set at the greater of $1,000,000 or 5 per cent of the company's market capitalization. See CSA Notice 53-302 – Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" (2000), 23 OSCB 7383.

[166] A misrepresentation is defined under subsection. 1(1) of the Act as: "(a) an untrue statement of material fact, or (b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made."

[167] The Civil Liability Amendments were published for comment in May 1998 (see (1998), 21 OSCB 3367).

[168] For example, the Civil Liability Amendments require a plaintiff to obtain leave of the court in order to bring an action. Before granting leave, the court must be satisfied that the action (i) is being brought in good faith and (ii) has a reasonable prospect of success at trial. The Civil Liability Amendments also require court approval before any action can be settled.

[169] See, for example, *Epstein* v. *First Marathon Inc.*, [2000] 2 B.L.R. (3d) 30 (Ont. S.C.), where the court denounced American-style strike suits. The court used its powers under the *Ontario Class Proceedings Act*, 1992, S.O. 1992, c. 6, which requires court approval of any settlement of a class proceeding commenced under the Act, to disallow a proposed settlement agreement which would have provided no benefit to the proposed shareholder class and a substantial payment to class counsel. Cumming J. held that approval of the settlement "would violate the public policy objectives underlying the legislature's enactment of the [Act]", and that the "plaintiff's class proceeding is counter-productive to all these objectives."

Chapter 11: The Closed System

The closed system has been a cornerstone of our prospectus exemption system for over 20 years. While the closed system was never easy to grasp, over the years it has become increasingly complicated and difficult to administer and comply with. This is largely due to the fact that previous blanket rulings (now rules), add and remove prospectus exemptions and vary hold periods that would otherwise apply under the Act. In addition, differences continue to exist across the country. Accordingly, we considered whether the closed system should be replaced with an alternative approach. As part of this analysis, we considered whether hold period and seasoning period restrictions are necessary. Peripherally, we also considered the existing prospectus exemptions and the need for uniformity in this regard across Canada.

11.1 What is the Closed System?

The requirement to issue a prospectus serves an important function. It requires the issuer to provide certain information to prospective investors to assist them in making their investment decision. In addition, the prospectus must be filed on SEDAR, which serves to ensure that the information contained in it is generally available to the marketplace and forms part of the issuer's general disclosure base. There are, however, situations in which investors either do not need the information set out in the prospectus or are able to obtain that information themselves. In these situations, the Act allows the issuer to avoid the time and expense of preparing a prospectus.

Prior to 1979, a prospectus was required if an issuer made a "distribution to the public." There was considerable confusion about the meaning of this phrase and, in particular, who constituted a member of "the public." In order to provide greater certainty about when a prospectus is required, the concept of a distribution to the public was eliminated and the "closed system" was introduced. Under the closed system, a prospectus is required for all distributions of securities unless a specific prospectus exemption is available. Securities issued pursuant to an exemption can be traded using a further exemption, but the system is "closed" in that other trades of those securities are prohibited unless a prospectus is filed and receipted or certain resale restrictions are satisfied. In this way, securities issued pursuant to a prospectus exemption become part of the "closed system" and are restricted from entering the secondary market. Generally, securities issued pursuant to an exemption can only be traded outside of the closed system (or in other words, become "freely tradeable") if the issuer is or has been a reporting issuer for a specified period of time and in some cases, subject to the further restriction that the securities have been held for a period of time.[170]

There are two aspects of the closed system that are critical to understanding how it works: "hold periods" and "seasoning periods." Under the Act, "hold periods" of six, 12 or 18 months used to apply to securities acquired under certain prospectus exemptions, which meant they could not be resold until they had been held for the required period of time. The CSA recently introduced more uniform hold periods which replace local hold periods that would otherwise apply. These new hold periods provide that securities acquired under prospectus exemptions cannot be resold until the later of four months (in the case of a qualifying issuer) or 12 months (for a non-qualifying issuer) after the date of the exempt trade or the date upon which the issuer becomes a reporting issuer.[171]

On the other hand, certain prospectus exempt trades do not attract hold periods but they are subject instead to "seasoning periods." Under the Act, securities acquired pursuant to prospectus exemptions which are subject to seasoning periods only become freely tradeable if the issuer has been a reporting issuer for at least 12 months and is not in default of any requirement under the Act. The rationale for seasoning periods is that, since the issuer has been a reporting issuer for at least one year, it has established a sufficient disclosure record so that purchasers do not require prospectus-level disclosure. Resales of these restricted securities into the secondary market without a prospectus (in other words, outside of the "closed system") are permitted only if the issuer is a reporting issuer. Multilateral Instrument 45-102 Resale of Securities (MI 45-102) harmonizes seasoning periods across the country, replacing the 12-month seasoning period under the Act with either a four-month (for qualifying issuers) or 12-month seasoning period (for non-qualifying issuers).

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[170] In order to become a "reporting issuer," a company is generally required either to file a prospectus or become listed on an exchange in Ontario recognized by the Commission.

[171] Multilateral Instrument 45-102 Resale of Securities (2001), 24 OSCB 5511.

Distributions of securities from a control block are permitted to be made without a prospectus, subject to compliance with hold periods, provided that the control block party gives the market advance notice by filing a notice of intention to sell and the seller certifies as to certain facts.

11.2 Problems with the Closed System

Under the closed system, every distribution either requires a prospectus or falls within a specific exemption. The certainty that this approach provides has come at a high cost in terms of complexity and inefficiency. The legislation cannot capture all of the conceivable transactions that fit within the policy objectives of the exemptions. Accordingly, issuers must apply for discretionary exemptive relief for specific transactions which may be similar to, but do not fit within the four corners of, available statutory exemptions. This adds time and expense to issuers' transactions. The commissions across the country must, in turn, spend considerable time and effort dealing with these applications for discretionary relief. When a specific type of transaction becomes commonplace, this gives rise to the need for recurring relief, because the Commission no longer has the ability to issue blanket rulings. It is difficult to see how the Act's twin goals of investor protection and enhancing capital markets efficiency are optimized through this process. In Chapter 6 of this Draft Report, we recommend that the Commission be vested with the power to issue blanket orders.

Hold periods and seasoning periods make the resale of securities issued under prospectus exemptions a very complex matter requiring expert legal advice. Compliance with this complex regime is a challenge. While the implementation of MI 45-102 has helped to force greater convergence of hold period and seasoning period requirements in closed system jurisdictions, prospectus exemptions and resale restrictions continue to differ from province to province.

Historically, prospectus exemptions have always varied across Canada. Recent reforms in Ontario, British Columbia and Alberta illustrate how regulators continue to be moving in different directions.[172] Trying to harmonize hold periods and seasoning periods without harmonizing the underlying prospectus exemptions to which they apply is a bit like serving the icing without the cake. Local considerations and differences in regional markets are often cited as the reason for differences in the nature of the prospectus exemptions provided for under local legislation. We believe that local considerations can be reflected in a single, harmonized set of exemptions that are available across the country.

Recommendation:

The closed system is overly inclusive, inefficient and complex. Most importantly, the system cries out for simplification and greater convergence of

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[172] See OSC Rule 45-501 Exempt Distributions, as contrasted with the new exemptions in British Columbia and Alberta: the "family, friends and business associates exemption," the "offering memorandum exemption," the "accredited investor exemption" and a modified "private issuer exemption" (Multilateral Instrument 45-103 Capital Raising Exemptions). These exemptions replaced a number of existing exemptions, including the "50 purchaser exemption," the "$25,000 sophisticated purchaser exemption" and the "friends and relatives exemption."

requirements across the country. We encourage the CSA to proceed with further reforms to the prospectus exemptions and the closed system with convergence of requirements and simplification as twin goals.

11.3 Recent Reforms to the Exempt Market Regime and the Resale Rules: Do They Go Far Enough?

(a) Exempt Market Reform

The closed system is based on specific exemptions from the prospectus requirement. The Act and subordinate legislation currently contain over 40 such exemptions. Some of these exemptions have been consolidated in one place through the adoption of OSC Rule 45-501 Exempt Distributions, which has effectively replaced various exemptions in the Act. OSC Rule 45-501 introduced two new exemptions - the "closely held issuer exemption" and the "accredited investor exemption." The private company exemption,[173] private issuer exemption,[174] $150,000 exemption,[175] and seed capital exemption[176] are no longer available in Ontario.

The recent exempt market reform in Ontario was largely based on the recommendations of *The Report of the OSC Task Force on Small and Medium Sized Businesses* (1996), 19 OSCB 5757. British Columbia and Alberta have also recently undertaken exempt market reform (see Footnote 172). Recently, the British Columbia Securities Commission published for comment a paper entitled "New Concepts For Securities Regulation," dated February 18, 2002. One of the concepts the paper advances is the Continuous Market Access System ("CMA"), which builds on the CSA's IDS proposals discussed in Chapter 10. Under the CMA, prospectuses would be replaced by an "evergreen" continuous disclosure system and there would therefore be no need for prospectus exemptions or resale restrictions for CMA issuers. In view of the timing of release of this Concept Paper, the Committee has not studied it in any detail. However, we will be interested in the public reaction and commentary on the concepts outlined in the B.C. paper.

We believe that simplifying the exempt market regime and achieving harmonization across Canada would be an important first step, even if it is only an interim step, towards a more radical, eventual overhaul of the regime.

(b) Need for Hold Periods

In the previous section, we described recent reforms aimed at harmonizing and reducing the length of the hold periods that apply to prospectus exempt trades. In this section, we ask whether reform should go further. Some commenters expressed concern with the length of hold periods. Few addressed the bigger question of whether they continue to be necessary at all. In considering this bigger question, the Committee discussed the various rationales underlying hold periods.

We identified three rationales for hold periods:

1. Hold periods prevent what are referred to as "back-door underwritings" – the use of a private placement exemption to effect a public distribution without preparing a prospectus.[177] Hold periods prevent an issuer from privately placing securities for immediate resale to the public without the benefits of a prospectus standard of disclosure and the rights and obligations that flow from the prospectus.

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[173] The Act, paragraph 35(2)10 and subsection 73(1).

[174] OSC Rule 45-501, s. 2.17.

[175] The Act, paragraph 35(1)5 and clause 72(1)(d).

[176] The Act, paragraph 35(1)21 and clause 72(1)(p).

[177] See the Merger Report, *supra* note 5.

2. They protect investors by ensuring that information about the issuer is available and disseminated in the marketplace through the issuer's continuous disclosure filings prior to permitting resale of the restricted securities.

3. Hold periods create an incentive for issuers to complete a public offering by reducing the price the private placee will pay for the securities given that they are not freely tradeable. In theory, public financings afford the investing public the greatest protection since a prospectus, with the liability and resultant due diligence it attracts, is filed.

With regard to the back-door underwriting issue, this concern could, perhaps, be addressed in a more targeted fashion. If private placees acquire securities with a view to distribution, this may bring them within the definition of "underwriter" under the Act and subject to the associated requirements. The definition of distribution could be tightened up to capture those trades which are "back-door underwritings" without subjecting all trades to a hold period.

With regard to the second rationale for hold periods described above, this does not appear to be particularly compelling today. The gap in the quality of disclosure as between the prospectus and continuous disclosure that existed when the closed system was introduced has narrowed considerably through regulatory reforms over the intervening period. In addition, while this suggested rationale for hold periods may support the need for seasoning periods, it does little to explain why hold periods apply even where an issuer has been a reporting issuer for a long period of time.

Lastly, there is not much rationale to support the use of hold periods to discourage issuers from using exemptions to sell to purchasers who fit within those exemptions. The key is to implement other reforms such as civil liability for continuous disclosure, upgrading continuous disclosure standards and moving towards a more integrated disclosure system so that opportunities for regulatory arbitrage are reduced, if not eliminated.

The CSA have recently gone a long way in reducing and simplifying hold periods to four months for qualifying issuers and 12 months for non-qualifying issuers. However, the rationale for hold periods is not as compelling as it once was. Once the other reforms we contemplate are in place, it may be time to take the next logical step and eliminate hold periods for reporting issuers.[178]

Recommendation:

Once other reforms are implemented, such as civil liability for continuous disclosure, enhanced continuous disclosure standards for all reporting issuers, more independent due diligence in connection with continuous disclosure and a more integrated disclosure system overall, we believe hold periods for securities of reporting issuers could be eliminated without sacrificing investor protection while contributing significantly to more efficient capital markets.

(c) Need for Seasoning Periods

Seasoning periods ensure that prospectus-level disclosure has been publicly available for a minimum period of time before securities of a reporting issuer acquired under a prospectus exemption may be traded outside of the closed system.

There are two elements of the seasoning period: 1) the issuer must be a reporting issuer; and 2) it must have been a reporting issuer for some minimum period of time before its securities can be traded outside of the closed system.

One commenter had this to say about seasoning periods:

> The requirement that an issuer be a reporting issuer ensures that the issuer is subject to continuous disclosure require-

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[178] See the comment letter of Torys which noted, at p. 5, that: "The specific hold periods were originally implemented for greater certainty as to when such a resale could occur but, based on experience, that objective has been outweighed by complexity and lack of cohesive purpose."

ments so that a purchaser in the secondary market will have the benefit of the continuous disclosure record. The need for a [12] month "seasoning period" is less obvious.[179]

We agree with this commenter. The usual justification for the reporting issuer "seasoning period" is that this allows time for information about the newly minted reporting issuer to be disseminated and absorbed by the marketplace. It also allows time for the quality of the issuer's disclosure to improve before trading of exempt securities in the secondary market is allowed. With regard to the former, we note that SEDAR and other technological advances permit greater and faster access to information than ever before. Improvements in dissemination and accessibility of corporate disclosure have been dramatic since seasoning periods were first introduced. To the extent that quality of disclosure is the issue, it is unclear that disclosure necessarily improves with the passage of time. Also, seasoning is not generally required to protect secondary market investors. For example, securities acquired under an initial public offering by prospectus can be immediately traded. If quality of disclosure is the real concern, perhaps it, too, can be addressed directly.

Recommendation:

As we have noted in connection with hold periods, if the reforms we contemplate in this Report are implemented, we believe the need for seasoning periods in the case of reporting issuers should also be revisited with a view to their elimination.

(d) Non-Reporting Issuers

As will be evident from the above discussion, the considerations which support re-examining the need for hold periods and seasoning periods in the case of reporting issuers do not apply to non-reporting issuers. Companies that are not obliged to provide the marketplace with a steady flow of continuous disclosure have not satisfied the condition pre-requisite for securities to be freely tradeable in the secondary market.

Recommendation:

The closed system should continue to apply to non-reporting issuers.

(e) Structuring Transactions to Avoid Control Block Hold Periods

Some commenters questioned the practice whereby control block holders or other insiders appear to hold large positions in companies they founded or manage, and yet have disposed of their economic interests through the use of lending or derivative arrangements ("monetization structures") that do not trigger the insider reporting requirement.[180] We deal with the need for insider reporting of these arrangements in Chapter 22. It was also noted that these monetization structures permit control block holders to cash out at significant premiums over the price paid for privately placed securities[181] while circumventing applicable hold periods in the process. Control block holders should be prevented from structuring transactions to avoid applicable resale restrictions. To the extent that hold periods apply to securities held by control block parties, the Commission should address the conduct of those who, directly or indirectly, contravene these requirements.

Recommendation:

The Commission should examine the practice whereby control block holders reduce applicable hold periods through the use of derivatives and other monetization structures. We recommend that the Commission issue guidance on this practice and, if necessary, utilize its public interest jurisdiction under section 127 of the Act to address it.

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[179] Comment letter of Torys.

[180] See Comment Letters of the Ontario Teachers' Pension Plan Board and TSX Venture.

[181] See Comment Letter of the IDA.

11.4 Where Do We Go from Here?

While we believe that there may be a need for "exempt financings," the restrictions imposed on these financings must be re-examined in the context of the evolution of the broader regulatory regime including:

(a) enhanced continuous disclosure standards across Canada;

(b) active continuous disclosure review programs by the Commission and other securities regulators across Canada;

(c) statutory civil liability for continuous disclosure;

(d) rigorous enforcement of continuous disclosure standards across Canada;

(e) appropriate escrow requirements applicable to securities held by management and insiders of companies that go public; and

(f) the move towards a more integrated disclosure system in Canada.

We envisage that exemptions for specific financings would continue to exist and would ideally be harmonized across Canada. Securities acquired in reliance upon these exemptions should not be freely tradeable until the issuer becomes a reporting issuer. In such an environment, we question whether there would be a continued need or justification for hold periods and seasoning periods. In view of the complexity of the current system, we question the level of compliance with the complex maze of rules relating to resales of securities that are subject to hold periods and seasoning periods. We do not believe the inefficiencies and cost of compliance associated with the existing regime are justified when weighed against the benefits.

Recommendation:

We believe that, as other reforms to secondary market regulation are implemented, there may be no need for hold periods and other resale restrictions. We encourage a public debate as to whether hold periods and seasoning periods – hallmarks of the existing "closed system" – continue to serve a public policy purpose or whether they are an idea whose time has come – and gone.

Chapter 12: Disclosure Standards

12.1 Material Fact, Material Change and Material Information

(a) Material Fact vs. Material Change in the Context of Continuous Disclosure

There is considerable confusion about the difference between a "material fact" and a "material change" and the purpose for which each of these terms is used in the Act. The distinction is perhaps best understood from the perspective of the evolution of an issuer's disclosure record.

As discussed previously, the prospectus is the base document for an issuer's disclosure. Both the preliminary and the final prospectus must contain full, true and plain disclosure of all *material facts* relating to the securities issued or proposed to be distributed. A "material fact" is defined as follows:

> "material fact", where used in relation to securities issued or proposed to be issued, means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities.

Any "fact" (specifically related to the issuer or not) will be a "material fact" if it significantly affects (or would reasonably be expected to have a significant effect on) the market price or value of the securities being issued.

After a preliminary prospectus has been filed, an issuer's disclosure record is driven by *material changes.* A "material change" is defined as follows:

> "material change", where used in relation to the affairs of an issuer, means a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the decision by the board of directors is probable.[182]

The concept of "material change" drives the issuer's disclosure in three ways. First, if a material *adverse* change occurs after a preliminary prospectus has been filed, an amended preliminary prospectus must be filed. Other material changes would presumably be "good news" material changes and prospective purchasers would not be prejudiced by waiting for "full, true and plain disclosure of all material facts" in the final prospectus, which would include all material changes since the preliminary prospectus. Second, after the final prospectus has been filed, until the time that the offering is "out of distribution," the issuer must file an amended prospectus if any material change occurs. Finally, the continuous disclosure requirements in the Act require the issuer to issue a press release and file a material change report when any material change occurs.

How does a material change differ from a material fact? First there must be a "change" (as opposed to the existence of a "fact"). Second, the "change" must be in the business, operations or capital of the issuer (a material "fact" can be unrelated to an issuer's business, operations or capital so long as it has a significant effect on the market price or value of the securities being issued). Issuers are not expected to continually interpret external political, economic, and social developments as they affect the affairs of the issuer, unless the external development will result in a change in the business, operations or capital of the issuer, in which case, timely disclosure of the change must be made.[183] However, we would expect that in the current environment reporting issuers would discuss external developments and the effect of such events on their companies in their interim and annual MD&A. Finally, the threshold for a "material change" is forward looking – the change in the business, operations or capital of the issuer must be one that *would*

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[182] The Act, subsection 1.1(1).

[183] Speech of former Chairman, Peter Dey, (1983), 6 OSCB 2368.

reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer.

The commencement of a major law suit may be a material fact (discloseable in a prospectus) but not a material change (and therefore not giving rise to a material change report and press release) because it does not constitute a change to the issuer's business, operations or capital. Similarly, it may be a material fact that an issuer has engaged financial advisers with respect to a recapitalization. However, until the issuer makes a decision to proceed, no material change has occurred.

(b) Material Information – Additional Disclosure Requirements

Although the Act requires public disclosure only of material changes, the TSX and the Commission began to move issuers to an enhanced disclosure standard in the mid-1980s. At that time, the TSX adopted a requirement that listed companies disclose all "material information" (a concept that incorporates material changes, material facts and certain other information). In 1987, the CSA supported this enhanced disclosure standard by adopting National Policy Statement 40 Timely Disclosure ("NP 40") recommending that issuers disclose all "material information." Material information is "information relating to the business and affairs of an issuer that results in or would reasonably be expected to result in a significant change in the market price or value of any of the issuer's securities."

NP 40 is a policy statement, not a rule. The CSA is proposing to rescind NP 40 in connection with the adoption of proposed National Policy 51-201 ("NP 51-201") Disclosure Standards because much of the guidance in NP 40 will be incorporated into proposed NP 51-201. The CSA has also determined that it cannot, through a policy statement, change the test for triggering continuous disclosure obligations prescribed by statute. The Committee therefore considered whether the policy thrust of the TSX's timely disclosure policy and NP 40 should form the basis of a legislative amendment requiring disclosure of all material information on a continuous disclosure basis.[184]

(c) Disclosure Standards in the United States

We note that U.S. issuers do not have a specific statutory duty to make timely public disclosure of material changes or material information.[185] Periodic reporting requirements, such as Form 8-K, have instead been used to complement, rather than duplicate, the various U.S. stock exchange rules, which generally require disclosure of all material information. In this regard, Ontario securities legislation already imposes a higher disclosure obligation than that of the United States by virtue of the requirement to make prompt disclosure of "material changes".

(d) Should the Disclosure Standard in Ontario Be Changed?

We received a number of submissions on whether reporting issuers should be required to disclose "material information" rather than "material changes" on an ongoing basis. Most were opposed to moving to this change.[186] Some noted that the current regulatory framework implicitly recognizes that it may be necessary for the proper functioning of the markets to require something less than full disclosure (such as in the context of incomplete negotiations). The commenters cautioned against a change that would disrupt this important policy consideration. For example, the IDA noted:

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[184] In 1995, the Allen Committee also considered whether the disclosure standard should be changed to "material information," the requirement under NP 40. In its interim report, it concluded that the distinction between "material facts," "material information" and "material changes" causes some confusion for market participants and has contributed to a "lack of clarity in the rules." *(See Interim Report of The Toronto Stock Exchange Committee on Corporate Disclosure, Toward Improved Disclosure* (1996), 19 OSCB at page 83.) In this regard, the Allen Committee concluded that NP 40 and the TSE "got it right." However, the Allen Committee encountered significant resistance to this proposal and did not pursue this recommendation in its final report.

[185] Unlike Ontario laws, U.S. federal securities laws impose no general duty to disclose material developments as they occur, except where: (i) it is necessary to correct a previous untrue statement that has become materially misleading and on which the market is still relying (i.e., *"duty to correct"*); (ii) it is necessary to update forward-looking statements or projections on which the market continues to rely that were true when made, but later became materially false or misleading in the context of subsequent events (i.e., *"duty to update"*); or (iii) the issuer is in the process of buying or selling its own securities or wishes to facilitate such transactions by insiders (i.e., *"duty to disclose or abstain"*) (J. Robert Brown, *The Regulation of Corporate Disclosure*, 3rd ed., (Aspen Law & Business: New York) at pages 3-5. The SEC is currently considering changes to this regime.

> The appropriate legal standard of materiality for the purposes of triggering a continuous disclosure obligation must strike a reasonable balance between the market's need to be informed on a timely basis of material developments concerning an issuer and the issuer's need for clarity as to the circumstances in which such disclosure must be legally made, particularly in light of the immediacy of the obligation. It is also essential to recognize that there are circumstances where an issuer (and its existing shareholders) legitimately has a need to keep material developments confidential. For these reasons, the IDA believes timely disclosure is best premised on "material changes" rather than "material facts" since in the latter case the issuer will typically require more time for thoughtful reflection as to the potential impact on share price or value of the development which has not yet progressed to the status of a change in the issuer's affairs. Premature disclosure of an intended financing or acquisition that may be considered a "material fact" is not beneficial for the secondary markets and can cause significant price interference for such transactions. For this reason, the IDA prefers the existing "material change" standard to a broader standard of "material developments".

The proposal to change the current trigger for making timely disclosure from a "material change" to "material information" has some appeal. By requiring prompt disclosure of "material information," there would be more information available to the marketplace, which in turn would enable investors to make more informed investment decisions. Removing the distinction between a "fact," "change" and "information" would also help to bring more clarity to this difficult disclosure area. There are two reasons, however, why we do not recommend that the disclosure requirement be moved to "material information." First, as one commentator to the Committee noted, the "issue of when to disclose becomes much more problematic and difficult for issuers when material information or facts must be disclosed, such as merger negotiations and financial difficulty, etc., especially when such disclosure can and will be reviewed in hindsight and in particular should statutory civil liability be instituted."[187] Phil Anisman's dissenting statement in the Allen Report also notes:

> Canadian securities legislation thus accommodates the fact that the materiality of corporate intentions and business plans develops with their progress and implementation. The legislation requires timely disclosure only after such plans have matured to the point where they are sufficiently firm that they may be characterized as a change in the issuer's business, operations or affairs, while recognizing that they may, if generally known, significantly affect share prices at an earlier stage and precluding those who are aware of them from using their knowledge to trade in the issuer's share before the change, and public disclosure, occurs.

Second, disclosure of all material information would impose a significant burden on issuers to continually monitor matters external to them for the purpose of informing investors.

We considered that each of the TSX, TSX Venture and the Bourse de Montréal has policies in place which have, in effect, expanded the timely disclosure obligations of listed companies.[188] The exchanges have established market surveillance divisions dedicated to monitoring the market, the media and the securities industry to detect and investigate situations that may require disclosure. In support of this market surveillance function, the exchanges have been proactive in issuing guidance notes to assist issuers in complying with exchange disclosure rules and to encourage issuers to make investor information more accessible, accurate and timely.[189] We therefore question whether it is necessary to recommend an expansion to the current regulatory regime which would, in effect, duplicate existing exchange rules.

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[186] See comment letters of Torys, the IDA, Simon Romano, TSX Venture, and Peter McCarter of Aur Resources Inc., who were opposed to such a change; whereas Smith Lyons was in favour of the proposed change. It should be noted, however, that Mr. McCarter expressed the view that, should statutory civil liability not be implemented, the requirement to disclose material information, as opposed to material changes, would be more palatable.

[187] See the comment letter of Peter McCarter.

[188] The exchanges require that all listed companies make timely disclosure of all material information. See the TSX, *Policy Statement on Timely Disclosure and Related Guidelines*, at http://tsers.com/; TSX Venture Policy 3.3 Timely Disclosure; and Bourse de Montréal Inc., Policy I-8 Timely Disclosure by Listed Companies.

One drawback to relying solely on exchange requirements in this area is that such policies are difficult to enforce. More specifically, if a violation occurs, an exchange can suspend trading in, or permanently delist, a company. Short of these relatively drastic and unlikely sanctions, however, the exchanges have little ability to penalize violators for a failure to disclose "material information." Moreover, delisting is often viewed as an inappropriate remedy because it penalizes an issuer's security holders by denying them the liquidity of an organized market rather then penalizing those directly responsible for the inadequate disclosure. We have tried to address this concern in our recommendations dealing with enforcement. Our recommendation to expand the Act's enforcement mechanisms by giving the Commission the power to order compliance with exchange rules (rather than legislating a new disclosure requirement) will enhance the Commission's ability to deal with companies that breach exchange rules.

We also note that if there are perceived gaps in information that is being disclosed by reporting companies on a continuous disclosure basis, the Commission has the necessary rulemaking authority to promulgate specific disclosure requirements similar to the SEC's Form 8-K approach noted above, and should be encouraged to do so where appropriate. Periodic reports, like the SEC's Form 8-K, should in our view be used to augment the existing framework of timely disclosure.

Recommendation:

We recommend that the Act's timely disclosure provisions not be amended to require disclosure of "material information."

12.2 What Is the Appropriate Standard for Materiality?

(a) Market Impact vs. Reasonable Investor Test

Under the Act, both "material change" and "material fact" are defined with reference to whether the change or fact "would reasonably be expected to have a significant effect on the market price or value of a security."[190] This "market impact" standard of materiality is common to all CSA jurisdictions other than Quebec.[191] In contrast, in the United States information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision. To satisfy the U.S. materiality standard, there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available."[192] This

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[189] See, for example, the TSX, *Policy Statement on Timely Disclosure and Related Guidelines, ibid.* and the TSX, *Electronic Communication Disclosure Guidelines*, at http://tsers.com/.

[190] By way of background, it should be noted that the terms "material fact" and "material change" are applied in many contexts under the Act. The terms "material fact," "material change" and "misrepresentation" (itself defined by reference to "material fact") apply in connection with: (i) disclosure requirements and remedies, including required standards of disclosure in such documents as prospectuses, offering memoranda, bid circulars, proxy circulars and material change reports, and remedies and sanctions for failures to meet the required standards of disclosure; and (ii) insider trading prohibitions, in relation to both the standard of materiality and remedies and sanctions for contraventions.

[191] It should be noted that the Quebec Act does not define the term "material fact" and Quebec courts have looked to U.S. jurisprudence to develop a different formulation of the materiality standard from that found in the legislation in other provinces of Canada.

[192] *TSC Industries, Inc.* v. *Northway Inc.*, [1976] 426 U.S. 428, 449.

"reasonable investor" test is not a statutory test, but has developed through case law.

In 1997, the CSA considered amending the definitions of "material fact" and "material change" by replacing the Canadian "market impact" test with the U.S. "reasonable investor" test.[193] The CSA received a number of comment letters, some of which were supportive. Some commenters raised a number of concerns, including that the proposed definitions raised too many issues of interpretation, that a single materiality standard was not viable and that such a change would introduce an unacceptable level of subjectivity and uncertainty.[194] The CSA ultimately decided not to pursue the proposed changes.

The comments we received on this issue reflect the continuing range of views on this issue. There are good arguments both to support preserving the status quo and to support a change in the materiality standard. Some proponents of the status quo argue that the current "market impact" test works reasonably well now and is a more objective test than the reasonable investor test. Others note that, since U.S. courts tend to consider market impact when applying the reasonable investor test, a change in the definition for Canadian law purposes would not produce a significant difference in result. Still others argue that this would require market participants to adopt a different disclosure standard, while contemporaneously becoming subject, for the first time, to a regime that imposes civil liability for non-compliance with such a standard. Accordingly, they argue that the implementation of any proposed change to the materiality standard should be delayed for some period until Canadian capital markets have adjusted to the implementation of the new liability regime.

Advocates of changing the materiality trigger to conform to the U.S. reasonable investor test argue that the standard of "full, true and plain" disclosure applicable to prospectuses is effectively the reasonable investor standard, and "if we aim to promote credible capital markets, the same standard should be applied to trigger continuous disclosure and to its contents."[195] We note also that this standard has already been imported into Ontario securities law in the context of specific regulatory instruments.[196] Others argue that harmonizing Ontario (and ultimately Canadian) securities law with U.S. securities law will eliminate some of the complexity issuers currently face in fulfilling their disclosure obligations, particularly issuers whose securities are traded in both Canada and the United States.[197]

Finally, some make the argument that there is really no difference between the Canadian "market impact" test and the U.S. "reasonable investor" test since a "reasonable investor" will only be concerned with whether a fact or change would affect the value of the security. This argument can be used to support a change to the Canadian test because it will in fact result in no practical change at all; it can also be used to support the status quo, since change in this case will not result in any meaningful difference in the disclosure standard.

The Committee deliberated extensively on this matter.

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[193] In November 1997, certain members of the CSA published for comment proposed amended definitions of "material fact" and "material change" which would have introduced a single materiality standard for all purposes under securities legislation based on the U.S. reasonable investor test (the "Request for Comment"). The proposed amended definitions were published again in May 1998 as part of the proposed amendments to securities legislation which would create a statutory civil liability regime for continuous disclosure. See CSA Notice 53-302 Report of the CSA – Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" (2000), 23 OSCB 7383.

[194] *Ibid.*

[195] Tory Tory DesLauriers & Binnington, *Canadian Securities Regulators Propose to Adopt Tougher U.S. Standards on Public Issuer Disclosure* (December 6, 1997).

[196] See, for example, Instruction 3 to Form 41-501F1 Information Required in a Prospectus.

[197] See, for example, the comment letter of Phillip Anisman, on behalf of the TSX, to the CSA dated December 22, 1997.

We acknowledge that compelling arguments have been made to support keeping the market impact test and to support replacing it with the reasonable investor test. Throughout this Draft Report, we have emphasized the need for increased regulatory harmonization, except where specific policy objectives preclude it. We believe that requiring issuers to contemplate what would be relevant to an investor is the appropriate standard and therefore recommend that the definition be changed to be consistent with the U.S. "reasonable investor" test.

Recommendation:

We recommend that the existing materiality standard should be changed for all purposes under securities legislation to a reasonable investor standard.

Chapter 13: Selective Disclosure

13.1 Selective Disclosure

Selective disclosure has received considerable attention in the last several years. The concern is with material non-public information that is disclosed to one or more individuals or companies and not broadly to the investing public. Much of the discussion has focussed on the SEC's Regulation FD, which became effective on October 23, 2000.[198] Regulation FD requires reporting companies to disclose material information through broad non-exclusionary public means rather than selectively to securities analysts and other market professionals.

Selective disclosure raises a number of issues. Most obvious is the unfairness resulting from some investors having material information before others and the opportunities that this creates for illegal insider trading. In adopting Regulation FD, the SEC also expressed the following concern:

> If [corporate managers] are permitted to treat material information as a commodity that can be parceled out selectively, they may delay general public disclosure so that they can selectively disclose the information to curry favor or bolster credibility with particular analysts or institutional investors. Moreover, if selective disclosure were to go unchecked, opportunities for analyst conflicts of interest would flourish. We are greatly concerned by reports indicating a trend toward less independent research and analysis as a basis for analysts' advice, and a correspondingly greater dependence by analysts on access to corporate insiders to provide guidance and "comfort" for their earnings forecasts. In this environment, analysts are likely to feel pressured to report favorably about particular issuers to avoid being "cut off" from access to the flow of non-public information through future analyst conference calls or other means of selective disclosure. This in turn raises concerns about the degree to which analysts may be pressured to shade their analysis in order to maintain their access to corporate management.

Prior to the adoption of Regulation FD, there was no express statutory prohibition against selective disclosure under U.S. securities laws. U.S. courts instead implied such a prohibition under the general anti-fraud provision, Rule 10b-5, in the 1934 Act. This approach led to uncertain results in establishing which type of selective disclosure was prohibited in the United States.[199] Given its recognition that issuers retain control over the precise timing, audience and means for important corporate disclosure, the SEC adopted Regulation FD as an issuer disclosure rule.

Canadian securities law, on the other hand, has a specific and comprehensive insider trading and tipping regime which prohibits, among other things, all selective disclosures except in the "necessary course of business."[200] However, notwithstanding the clear statutory prohibition on selective disclosure in Canada, Canadian issuers have not always complied with this prohibition. In 1995, the Allen Committee raised concerns about the practice of selective disclosure in private meetings between issuers, analysts and professional investors.

In 1999, the Commission conducted a random survey of the corporate disclosure practices of 400 public companies. The survey indicated that "the extent and nature of corporate disclosure policies and practices of reporting issuers in Ontario is not sufficient to reduce the potential for selective disclosure".[201]

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[198] See Release Nos. 33-7881, 34-43154, IC-24599, File No. S7-31-99 Selective Disclosure and Insider Trading.

[199] See, for example, *Dirks* v. *SEC*, [1983] 463 U.S. 646, in which the U.S. Supreme Court stated that an analyst tippee would be subject to insider trading liability if the tipper breached a fiduciary duty to shareholders in disclosing material non-public information and the tippee knew or should have known of the breach. As articulated by the Supreme Court, breach of a fiduciary duty exists where the "insider" will benefit, directly or indirectly, from the disclosure. This benefit may be in the form of a pecuniary gain or reputational benefit that will translate into future earnings.

[200] In Ontario, see subsection 76(2) of the Act.

In May 2001, the CSA published for comment a proposed policy statement that discusses the Canadian legislative prohibitions against selective disclosure and sets out the CSA's views concerning the interpretation of these provisions.[202] The policy statement also highlights some "best disclosure" practices that companies can adopt to ensure that they comply with securities legislation.

In November 2001, the Analysts Standards Committee issued its final report, *Setting Analysts Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts.* The Analysts Standards Committee was formed in late 1999 by the IDA, the TSX and TSX Venture "in response to concerns about the supervision of research analysts, the standards of practice and how analysts deal with potential conflict of interest situations."[203] The final report contains a number of recommendations aimed at improving the independence of research and ensuring the professional practice of securities industry analysts, including recommendations for dealing with the practice of selective disclosure. In particular, the Analysts Standards Committee recommended that:

- the Saucier Committee should consider, as part of the corporate governance responsibility of a company's board of directors, the need for the development and review of a communications policy that addresses how a company's management interacts with analysts and the public, and how the company avoids selective disclosure; and
- public companies include the media and investors in analyst meetings and conference calls, thereby avoiding the risk of selective disclosure.[204]

We share the concerns expressed by the above-noted committees and securities regulators. We are also troubled by the recent reports of selective disclosure in the media and the impact of this practice on market integrity in Canada. Indeed, while issuer selective disclosure may not be a new phenomenon, the effect of such selective disclosure appears to be much greater in today's more volatile, earnings-sensitive markets. This is particularly disturbing when one considers that advances in communications and information technologies have made it easier for companies to disseminate important information more broadly and quickly. We endorse the CSA approach. We believe that guidance from the CSA in the form of a policy statement coupled with increased emphasis on enforcement in this area[205] should be adequate to change market behaviour. [206]

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[201] For example, 71 per cent of the respondents did not have written corporate disclosure policies; 81 per cent of the respondents reported that they have one-on-one meetings with analysts; 98 per cent of the respondents reported that they typically comment in some form on draft analyst reports; and 27 per cent of the respondents indicated that they express a level of comfort on earnings projections. See Ontario Securities Commission Staff Notice 53-701 Staff Report on Corporate Disclosure Survey (2000), 23 OSCB 5098.

[202] See proposed National Policy Statement 51-201 Disclosure Standards.

[203] TSX News Release, "Analyst Standards Committee recommends Mandatory Disclosure," April 12, 2001 (http://www.tse.com/news/news_rel/news_523.html).

[204] *Setting Analysts Standards: Recommendations for the Supervision and Practice of Canadian Securities Industry Analysts* (October 2001 – Final Report) at pages 72 and 73, at (http://tse.com/cgi-bin/uni_framset.cgi?content=news/news_rel/news_523.html).

Recommendation:

While the Committee does not believe that legislative change is required in Ontario to address the issue of selective disclosure, we support the CSA's policy statement and an increased emphasis on enforcement in this area.

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[205] See *In the Matter of Gary George* (1999), 22 OSCB 7171, where the Commission addressed in obiter the issue of a selective disclosure made by an issuer's chief executive officer to an analyst and the subsequent disclosure by the analyst to other members of his firm:

> It would appear that some corporate officers see the maintenance of good relations with analysts as being more important than ensuring the equality of material information among shareholders. The fact that it was thought [the analyst] was about to come out with a report as to [the issuer] which would overvalue its shares would in no way justify [the President] giving the information to [the analyst] rather than publicly disseminating it. If the information was material enough to cause [the analyst] to change his projections, it should have been publicly disseminated. In general, we view one-on-one discussions between an officer of a reporting issuer and an analyst as being fraught with difficulties.

In August 2001, the Commission approved a settlement agreement reached between Commission staff and Air Canada with respect to Air Canada's alleged disclosure of earnings information to analysts during the company's self-imposed "quiet period". In the *Excerpt from the Settlement Hearing Containing the Oral Reasons For Decision*, the Commission stated: "Communication by a corporation with analysts is not covered under some exception; so what is disclosed to analysts, if it is material and will significantly affect the market price, or reasonably may be expected to significantly affect the market price of the shares of the issuer, should not be selectively disclosed" ((2001), 24 OSCB 4899).

[206] The Committee also received several submissions in which all of the commenters agreed that there are sufficient rules in Canada concerning selective disclosure. See the comment letters of Smith Lyons, the IDA, and The Canadian Bankers Association.

Chapter 14: Financial Statement Issues

14.1 Financial Statement Disclosure

We believe that there are a number of improvements that need to be made in the financial reporting requirements set out in the Act. These improvements are described below.

(a) Timing of Release of Financial Statements

Reporting issuers must deliver quarterly financial statements to their shareholders (and file those statements with the Commission through SEDAR) no later than 60 days after the end of the quarter. They must deliver annual audited financial statements to their shareholders (and file those statements with the Commission through SEDAR) no later than 140 days after the end of the fiscal year.

In our view, the 60 and 140 day filing deadlines are out of date. The fact that issuers routinely release quarterly and year end financial information well in advance of the date on which their financial statements are filed and sent to shareholders supports this contention. Information technology advances have increased the speed at which financial information can be collected and analyzed.

The CSA is considering shortening the time periods for the filing of annual and interim financial statements from 140 and 60 days to 90 and 45 days, respectively, after the end of a company's reporting period.[207] We support this initiative. We note that the time periods being proposed by the CSA are the time periods currently prescribed in the United States and that the SEC recently proposed further shortening these time periods to 60 and 30 days.

Recommendation:

We recommend that the periods for filing annual financial statements be reduced to 90 days after the fiscal year end and that the time periods for filing interim financial statements be reduced to 45 days after the end of each quarter.

(b) Auditor Review of Quarterly Financial Statements

In Ontario, quarterly financial statements must be reviewed by the board of directors or audit committee.[208] This requirement was introduced in 2001 as a means of promoting the integrity of the financial statements and the role of the audit committee. If the board or audit committee does not play a role in the review of quarterly financial statements, then management is in control of the issuer's financial disclosure until year end, when the audit committee is required to review the annual financial statements before they are approved by the board of directors. At that point, if the audit committee has any issue with the accounting policies or judgments applied by management in preparing the financial statements, fourth quarter adjustments can become an issue. Requiring the involvement of the audit committee at the end of each quarter reduces the potential for problems in this area.

The Act does not require external auditor review of the quarterly financial statements, although the Commission recommends it.[209] The approach in the United States is the opposite. The 1934 Act requires auditor review of interim financial statements before they are filed with the SEC, but leaves it up to the issuer whether the board or audit committee should review the statements before they are filed. In our view it should be apparent to every board and audit committee that the auditors should review the quarterly financial statements. There is otherwise the potential for management and the audit committee (who approved the first three quarters) to be pitted against the auditors in the course of the audit and review of the annual statements. We recognize that there will be additional costs associated with an auditor's review of the interim statements. However, in light of the importance of the integrity of financial statements, we believe that this additional cost should be accepted as a cost of being a public company.

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[207] This proposal was extracted from the IDS concept paper, discussed in Chapter 10.

[208] OSC Rule 52-501 Financial Statements, subsections 2.2(6), (7).

[209] Companion Policy 52-501 CP to OSC Rule 52-201 Financial Statements, s. 2.1.

Recommendation:

Ontario securities legislation should be amended to require that quarterly financial statements must be reviewed by the issuer's external auditor.

(c) Release of Financial Information Prior to Board Approval

The release of financial information before interim and annual financial statements are approved by the board of directors or audit committee is also an issue of concern. Many issuers announce their earnings or other financial information soon after the end of a reporting period, but well before the financial statements themselves have been finalized and approved. We think that this is inconsistent with the requirement under Ontario securities law that such statements receive board (or audit committee) approval, and creates further potential for the audit committee to be backed into a corner by management when it comes to approving the statements.

(d) Non-GAAP Financial Information

Many issuers use non-GAAP numbers in communicating the results of operations to the public. The danger in non-GAAP numbers is that there is no common understanding of what they mean. There is therefore little basis for comparison of these numbers from one issuer to another. Moreover, they offer too much of an opportunity for an issuer to create a number that casts the financial results in a more positive light than would be the case if the numbers were derived from the financial statements. This practise was the subject of a CSA staff accounting notice early in 2002.[210] We recommend that the CSA monitor the use of non-GAAP or pro forma numbers in corporate disclosures to determine whether the CSA staff notice is causing companies to be more balanced in their financial disclosure. If not, the CSA should consider whether more aggressive regulatory intervention is warranted.

(e) Filing Press Releases Containing Financial Information

Reporting issuers issue press releases for a variety of reasons. As discussed above, they may be required by the Act to disclose a "material change" by way of a press release. The press release announcing the material change is appended to the material change report and filed on SEDAR. It is therefore readily accessible to anyone looking for the issuer's current disclosure record.

There are obviously a number of other reasons why issuers issue press releases. They may have "good news announcements" they wish to share with their investors or other constituents. They may simply wish to increase their profile or attract media attention. If the information does not constitute a "material change," an issuer typically won't file a copy of the press release on SEDAR.[211] In many cases, the investing public will not be prejudiced by not being able to access such press releases on SEDAR. Moreover, there are drawbacks to requiring all press releases to be filed on SEDAR. A requirement to file every press release would result in important information being buried. It could also lend legitimacy to promotional news releases.

However, reporting issuers may also wish to disseminate certain information which they do not necessarily characterize as a "material change," but which, in our view, should form part of the issuer's publicly available disclosure record (and, accordingly, should be filed on SEDAR). The issue that concerned us particularly is the release of earnings information in advance of the release of the financial statements.

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[210] CSA Staff Notice 52-303 Non-GAAP Earnings Measures.

[211] It may make a copy of the press release available on its website under "Investor Information", but it is under no obligation to do so.

In our view, news releases of this type should form an integral part of an issuer's continuous disclosure record and such releases should be filed on SEDAR. Once the issuer's financial statements have been approved, as discussed above, then their release or the release of earnings information derived from them which has also been approved should be filed on SEDAR. This will ensure that this important disclosure is readily accessible to investors, to Commission staff conducting continuous disclosure reviews or investigating possible disclosure breaches, and to the marketplace generally.

We invite comments on whether there are any other definable categories of press releases that reporting issuers should be required to file on SEDAR.

Recommendation:

Ontario securities legislation should be amended to require that press releases containing financial information or earnings information must be filed on SEDAR.

(f) Generally Accepted Accounting Principles

The Act requires reporting issuers to file with the Commission and deliver to shareholders financial statements prepared in accordance with Canadian GAAP. In Part 1 we discuss the need to harmonize our financial reporting with the rest of the world, particularly the United States, and recommend that the Act be amended to allow reporting issuers to prepare their financial statements in accordance with U.S. GAAP or IAS subject to appropriate transitional periods.

(g) The GAAP Exemption for Banks and Insurance Companies

Although reporting issuers are required to prepare their financial statements in accordance with GAAP, the Regulation under the Act provides an exemption[212] from this requirement for banks listed in Schedule I or II to the *Bank Act* and life insurance companies licensed under the *Insurance Act* if their financial statements are "prepared in accordance with a statute incorporating, continuing or governing the bank or insurance company and any applicable GAAP."[213] Under federal legislation, OSFI has the authority to mandate accounting practices by regulated financial institutions. The effect of these sections is to allow OSFI to prescribe how Canadian GAAP should be applied and even to override GAAP.[214]

The GAAP exemption for banks and life insurance companies reflects the tension that sometimes exists between the objectives of securities regulation and prudential regulation. The focus of securities regulation is to ensure that capital markets and market participants operate in a transparent environment and that individuals have a full and fair base of information to allow them to make investment decisions.

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[212] Subsection 2(3) of the Regulation.

[213] We understand that this exemption was originally adopted when banks, life insurance companies and property and casualty insurance companies were not fully included in the scope of the CICA Handbook. Over time, however, these institutions were brought fully within the scope of the Handbook. More specifically, the exemptions relating to property and casualty insurance companies, life insurance companies and banks were removed from the Handbook in September 1986, December 1987, and August 1992, respectively. A similar exemption exists in the securities legislation of Alberta and Manitoba. The Quebec Act contains a similar exemption for banks only. Securities legislation of the remaining provinces and territories does not contain such an exemption. The exemption was removed from the British Columbia Act when banks and insurance companies were brought within the scope of the Handbook.

[214] See, for example, subsection 308(4) of the *Bank Act*, S.C. 1991, c. 46.

Prudential regulation, on the other hand, focuses on preserving the safety and soundness of financial institutions. This difference in focus has the potential to create conflicting priorities. For example, in some cases prudential regulation may favour delayed disclosure or non-disclosure of certain events whereas securities regulation would require full and prompt disclosure.

Amendments to the *Bank Act*, contained in the FCAC, give OSFI the same power to override GAAP for bank holding companies.[215] This power appears to go beyond the existing override provision in securities legislation and raises additional implications as a result. Whereas existing regulations to the Act only contain special provisions for issuers incorporated under the *Bank Act* and the *Insurance Act*, under the amendments to the *Bank Act* it appears that alternative financial statements may be prepared by holding companies that are reporting issuers but are not incorporated under the *Bank Act*.

While we appreciate the different focus of securities and financial institution regulation, we nonetheless have concerns about the current GAAP exemption available to banks and insurance companies under the Act and the extension of the GAAP override under the FCAC Act. We believe that disclosure is an important part of any regulatory regime. Disclosure requirements provide information on which investors can base their choices. We further believe that good accounting standards are a necessary precondition for sound market regulation and can help to stabilize market expectations. We note that the current GAAP exemption makes it difficult for Commission staff to undertake disclosure reviews of such institutions. Moreover, we note that the circumstances in which OSFI has exercised an override of GAAP are company specific, which can create arbitrary differences that distort comparability of reported results both among financial institutions and with other entities. For example, we understand that this statutory power has recently resulted in some banks, acting under a directive from OSFI, applying accounting treatments that are contrary to Canadian GAAP in respect of increases made to their loan loss provisions. In each case, OSFI permitted the bank in question to depart from GAAP by taking a charge for an increase in loan loss provisions through retained earnings rather than through the income statement. In at least one of these cases, the absolute amount of the loan loss provision after the increase was in excess of the amount permitted under GAAP. Given the choice between non-GAAP and GAAP reporting, the Committee ultimately favours transparency and the use of GAAP.

There is no GAAP exemption available to banks and insurance companies in the United States. The SEC requires GAAP financial statements from all of its reporting issuers. U.S. banking and insurance regulators can prescribe accounting methods to be applied in special purpose filings with them, but to the extent those methods depart from GAAP, they would not be acceptable for purposes of filings with the SEC. This approach appears very sensible to the Committee.

We prefer the approach adopted in the United States, for the reasons set out above. An alternative (but less satisfactory approach), would be to only permit the GAAP override for prudential purposes, where the solvency of the institution or the financial services system would otherwise be placed at risk. The role of OSFI is as a prudential regulator; if it is to have any override powers in respect of securities legislation, they should only be exercisable in circumstances where there is demonstrable prudential concern. We invite comment on whether the GAAP override should be eliminated, as we prefer, or modified so as to be exercisable only where there is demonstrable prudential concern. In conclusion, we believe the current GAAP override is far too broad and we reject it being extended under the FCAC Act.

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[215] See s. 183 of the *FCAC Act*, which amends subsections 840(4) and 855(2) in Part XV Bank Holding Companies Division 6 of the *Bank Act*.

Recommendation:

We recommend that the GAAP exemption available to banks and insurance companies in subsection 2(3) of the Regulation to the Act be removed. Alternatively, we believe that the GAAP exemption should be limited to permit OSFI to override GAAP only where there is demonstrable prudential concern in order to contain or prevent solvency risk. The recent amendments to the GAAP override relating to bank holding companies should also be reconsidered.

14.2 Audit Committees

Most (although not all) Canadian corporate statutes require public companies to have an audit committee comprised of at least three directors (at least two of whom must be outside directors).[216] The audit committee's statutory mandate is to review the issuer's annual audited financial statements before they are approved by the issuer's board of directors.

Although the statutory provisions relating to audit committees have changed very little since they were first introduced, best practices have established higher standards in terms of audit committee composition as well as broader mandates for audit committees. The CSA released a Notice on Audit Committees in 1990, responding to questions raised by issuers about the role and responsibilities of audit committees.[217] Building on some of the recommendations in the CSA Notice, the TSX issued the TSX Guidelines in 1995.[218] The TSX Guidelines recommend that an audit committee be composed only of outside directors and that the audit committee have a written mandate, direct communication channels with inside and outside auditors and oversight responsibility with respect to management reporting on internal controls.

Recent developments in the United States have refocused attention in Canada on the importance of effective audit committees for the integrity of the financial reporting system. In September 1998, in response to growing concerns about reporting issuers misapplying U.S. GAAP in order to manage earnings expectations, former SEC Chairman Arthur Levitt launched an initiative aimed at improving the credibility and transparency of financial disclosure.[219] At the request of the SEC, the NYSE and NASD sponsored the Blue Ribbon Committee. In February 1999, the Blue Ribbon Committee released its report containing 10 recommendations aimed at strengthening the role of corporate audit committees in overseeing the financial reporting process. The specifics of the Blue Ribbon Committee's recommendations on audit committees dealt with the composition and mandate of the audit committee, particularly the processes by which the audit committee could enhance the independence of outside auditors.

The Blue Ribbon Committee's recommendations have been adopted, with some modification, by the SEC, the NYSE, the NASDAQ, the American Stock Exchange, and the accounting profession.

In July 2000, the TSX, TSX Venture and the CICA sponsored the Saucier Committee. The terms of reference of the Saucier Committee asked it to respond to the new U.S. requirements adopted as a result of the Blue Ribbon Committee Report. The Saucier Report was released in November 2001 and recommends that the TSX Guidelines be amended in a number of ways to bring them into line with the U.S. requirements. It did not recommend that all of the requirements now incorporated in the U.S. securities regulatory and stock exchange requirements be adopted here, but the differences that will exist are not significant and we do not propose to revisit the analysis conducted and conclusions reached by the Saucier Committee. With respect to audit committees, the Saucier Committee recommended that:

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[216] Audit committees are not required under the corporate statutes of Nova Scotia, Prince Edward Island or New Brunswick.

[217] See CSA Notice 52-301 Audit Committees. We have found that there is comparatively little in subsequent literature (including the U.S. Blue Ribbon Commission Report discussed below) that was not covered in the CSA Notice on Audit Committees, other than the financial literacy of members of the audit committee.

[218] Section 474 TSX Company Manual. The TSX Guidelines are based on the recommendations of the Dey Committee. The Dey Report proposed a number of practices that companies should follow in order to improve corporate governance.

[219] See SEC Press Release, "NYSE Chair Richard Grasso, NASD Chair Frank Zarb, and Blue Ribbon Panel Co-Chairs Ira Millstein and John Whitehead Announce 'Ten-Point Plan' to Improve Oversight of Financial Reporting Process" at http://www.sec.gov/news/press/pressarchive/1999/99-14.txt.

- audit committees should be composed exclusively of outside, "unrelated" directors (with some flexibility for TSX Venture Tier 2 companies that have small boards);
- all members of the audit committee should be financially literate, as determined by the board, with at least one member having accounting or related financial expertise;
- the audit committee should: (i) adopt a written mandate, approved by the board, setting out its responsibilities, specifically with respect to its relationship with external and internal auditors, its oversight of internal controls and disclosure of financial and related information; (ii) disclose the mandate to the shareholders; and (iii) conduct a regular assessment of the committee's effectiveness; and
- compliance with the U.S. audit committee requirements would be consistent with the Saucier Committee's recommendations.[220]

There has been a strong preference in Canada not to legislate corporate governance practices beyond what is currently provided in the corporate statutes. The prevailing view has been that best practice guidelines, coupled with disclosure requirements, would drive most issuers towards best practices that were most appropriate for them. However, in light of the importance of the financial reporting process to the integrity of an issuer's financial statements and the regulatory force of audit committee standards in the United States, it is appropriate today to look for a means of establishing a common standard in this area and enforcing compliance with that standard.

As we mentioned at the outset, the requirement for audit committees had its genesis in corporate law statutes. However, we believe that all reporting issuers should have audit committees and audit committees in Ontario should all operate to the same standard. Accordingly, we support legislative amendments that would provide the Commission with rulemaking authority relating to the functioning and responsibilities of audit committees. Moreover, we think it is also important that reporting issuers in all Canadian jurisdictions hold their audit committees to a consistent standard. Accordingly, we encourage the other CSA jurisdictions to provide their Commissions with similar powers and for the CSA to work together on an expedited basis to establish standards for audit committees that will place Canadian audit committees in the "best of class" internationally.

Recommendation:

We recommend that the Commission be given rulemaking authority to prescribe requirements relating to the functioning and responsibilities of audit committees of reporting issuers. We encourage other CSA jurisdictions to give their commissions similar powers, and we urge the CSA to work together on an expedited basis to establish standards for audit committees which will make Canadian audit committees "best in class" internationally.

14.3 Auditor Independence

In November 2000, the SEC adopted extensive amendments to its rules regarding auditor independence and adopted new disclosure requirements aimed at:

- fostering high quality audits by minimizing the external factors that will influence an auditor's judgment; and

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[220] The Saucier Report at page 29.

- promoting investor confidence in the financial statements of public companies.[221]

The new rules essentially provide that an accountant is not independent if he or she cannot exercise "objective and impartial judgment" or if a reasonable investor would conclude that an accountant cannot exercise objective and impartial judgment. This determination is based on the circumstances of the particular case, but the SEC has also provided specific rules on some common situations that raise independence issues. In particular, the rules identify particular services, relationships or interests that the SEC regards as incompatible with independence.[222]

The SEC rules further require companies to make certain disclosures in their proxy statements regarding relationships between a company and its auditors. In particular, companies must disclose:

- audit fees, fees paid for information technology services and other non-audit fees, under separate prescribed captions;

- whether the audit committee considered whether the outside auditor's provision of non-audit services is compatible with the auditor's independence; and

- whether the audit engagement was staffed primarily by leased personnel.

The SEC rules on auditor independence generated significant debate, particularly with respect to the issue of whether auditors should be permitted to provide consulting and information technology services to their audit clients. Proponents of the rules argued that accounting firms that provide consulting services to their audit clients aren't truly "independent" because consulting work creates an incentive for auditors "to go easy on their clients," either to win more contracts or to prove that the advice of their colleagues was appropriate. Detractors, on the other hand, expressed concern that the rulemaking initiative would hurt businesses and that audits actually improve when firms perform auditing and non-auditing functions because it gives them a more comprehensive picture of a company's financial health. They also argue that the professional integrity of auditors creates an effective barrier to conflicts of interest.

In Canada, the CICA Assurance Handbook requires that auditors have "an objective state of mind." Provincial rules of professional conduct also contain broad principles regarding objectivity and require that an auditor be free of influence that would impair its judgment "or which, in the view of a reasonable observer, would impair … professional judgment or objectivity."[223] Unlike the U.S. standards, current standards in Canada do not contain specific prohibitions on the scope of services that auditors may perform for their audit clients.

On January 14, 2002, the IFAC, of which the CICA is a member, released an updated Code of Ethics for

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[221] See Final Rule, Revision of the Commission's Auditor Independence Requirements, Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56; File No. S7-13-00. The rules became effective February 5, 2001, with transition periods for various types of transactions and relationships.

[222] The rules identify nine non-audit service functions that may not be performed by independent auditors for public company audit clients. For example, the auditor may not operate a client's information technology systems. Information technology consulting is allowed, however, under certain conditions. Management must acknowledge that it has responsibility for its internal controls. Management must also identify who will make all decisions regarding the information technology project. This individual may not use the auditor's work as the primary basis for determining whether the information technology system is adequate. An auditor's independence is also impaired by performing more than 40 per cent of the audit client's internal audit work related to the internal accounting controls, financial systems, or financial statements, unless the audit client has $200 million or less in assets.

[223] Institute of Chartered Accountants of Ontario, Rules of Professional Conduct Rule 204.1 (Objectivity: audit engagements); see also Institute of Chartered Accountants of British Columbia, Rules of Professional Conduct, Rule 204.1 (Objectivity – Assurance and Specified Auditing Procedure Engagements).

Professional Accountants which included new rules on auditor independence.[224] We understand that the Public Interest and Integrity Committee of CICA is undertaking steps to revise the Canadian independence standards of each provincial institute. The CICA intends to use the new IFAC requirements as a starting point in this process and anticipates adopting rules for all Canadian companies that are generally as rigorous as corresponding SEC rules. The CICA anticipates releasing the proposed rules for comment later this year. Similarly, in February 2002, a subcommittee of the independent AcSOC was formed to identify and review any accounting and financial reporting issues raised by the Enron failure and whether changes need to be made to Canadian standards.

The Committee has been following with interest the SEC's auditor independence rulemaking initiative and the new spotlight that has emerged on auditor independence in the wake of Enron's collapse. Many commenters believe that the time has come to ban auditors from providing consulting services to their audit clients. Some believe that this does not go far enough and that auditors should be prohibited from providing all non-audit work for their clients (such as tax and M&A advice). Others are calling for mandatory auditor rotation and the creation of a new independent regulatory body that would have direct power over the accounting profession's disciplinary and audit quality control programs. What conclusions will emerge from the Enron investigation are unclear.

We believe that auditors play a critical role in promoting investor confidence in the integrity and reliability of financial disclosure. In an era when companies face extreme pressure to report ever-increasing profits, and the markets severely punish those who don't meet expectations, auditor independence is vital. In light of the ongoing developments in the United States and the recent CICA and AcSOC initiatives, it would be premature for us to make any recommendations for reform relating to the substantive standards applicable to auditor independence. This is an area that requires careful study and we look forward to seeing the rule proposal of the CICA and the report of the AcSOC.

We urge the Commission to pro-actively monitor developments in this area to ensure that Canada does not lag behind international standards and that the auditing function remains a relevant and credible foundation upon which our financial disclosure system rests. In the meantime, we recommend that the Commission adopt amendments to its proxy disclosure rules similar to those already adopted in the United States, requiring companies to disclose amounts they pay to their auditors, both for auditing services and for non-auditing services. As noted by the SEC, such disclosure rules ultimately allow "investors to evaluate for themselves whether the proportion of fees for audit and non-audit services causes them to question the auditor's independence." In this regard, we believe that sunlight is the best disinfectant.

Recommendations:

1. **We urge the Commission to pro-actively monitor ongoing U.S. developments relating to auditor independence and to consider what reforms are necessary to ensure that Canada does not lag behind international standards.**

2. **We recommend that the Commission adopt amendments to proxy disclosure rules to require public companies to disclose in their proxy statements their expenditures for both audit and non-audit consulting services.**

14.4 Investor Reliance on Audited Financial Statements

Securities law requires all reporting companies to have their financial statements audited on an annual basis. In this regard, auditors are entrusted with an important public interest mandate: to examine objectively and comment on the fairness of the financial statements of reporting companies.[225] We believe the stability of our capital markets depends on the integrity of this financial reporting process.

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[224] See http://www.ifac.org. The new IFAC code emphasizes that independence is a "state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism".

The courts have called into question the extent to which the public is entitled to rely on audited financial statements. In *Hercules Management Ltd.* v. *Ernst & Young*,[226] the Supreme Court of Canada held that auditors owed no duty of care to shareholders in respect of their personal investment decisions.[227] We believe that the *Hercules* decision helps to underscore the importance of the CSA's proposed Civil Liability Amendments discussed previously in Chapter 10. Holding auditors accountable to investors who place reliance on audit reports in making investment decisions should serve to enhance the utility and integrity of these reports.

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[225] *Protecting the Public Interest: The Role of the Chartered Accountancy Profession*, prepared for the CICA by Kroll Associates (2001) at page 2 (http://www.cica.ca/cica/cicawebsite.nsf).

[226] [1997] 2 S.C.R. 165, where shareholders brought an action against a firm of accountants alleging that audits of the company's financial statements had been negligently prepared and, as a result, the shareholders had incurred investment losses.

[227] The court concluded that "to come to the opposite conclusion … would be to expose auditors to the possibility of indeterminate liability, since such a finding would imply that auditors owe a duty of care to any known class of potential plaintiffs regardless of the purpose to which they put the auditor's reports."

PART 5

ENHANCING FUNDAMENTAL SHAREHOLDER RIGHTS

When individuals buy shares in a company, they become owners of part of that company. Share ownership entitles investors to certain rights. Some of these rights relate to financial aspects of owning securities, and some relate to the communications between the company and the security holder. In this part, we discuss reforms aimed at enhancing shareholders' rights, including reforms in the area of proxy solicitations, take-over bid regulation and mutual fund governance.

Chapter 15: Shareholder Rights

Recent amendments to the CBCA (the "CBCA Amendments") are intended to facilitate communications among shareholders.[228] The Committee examined these amendments to determine whether comparable reforms are necessary under the Act.

15.1 Background

The CBCA contains provisions relating to shareholder meetings, materials to be provided to shareholders in advance of such meetings, and the process for soliciting proxies from shareholders who are unable to attend the meeting. These provisions were largely based on the Kimber Report, which was concerned that shareholders who are unable to attend meetings in person be able to appoint their own nominees to vote at meetings of shareholders. [229] Otherwise, the Kimber Report noted, the "marked tendency for management to perpetuate itself in office" would not be held in check and shareholders who were unable to attend meetings would not have a voice in the management of the company. The Kimber Report recommended that management provide an information or "proxy" circular to shareholders which contains sufficient information to enable shareholders to be knowledgeable about the proposals on which they are required to cast a vote.[230]

The Act requires management of a reporting issuer to send a form of proxy to voting security holders in connection with every shareholder meeting.[231] Persons other than management (typically referred to as "dissidents") may also solicit proxies. The Act further provides that no one (whether management or dissident) shall solicit proxies unless the proxy is accompanied by an information circular.[232]

The terms "solicit" and "solicitation" are broadly defined and include: any request for a proxy, any request to execute or not to execute a form of proxy or to revoke a proxy, and "the sending or delivery of a form of proxy or other communication to a security holder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[233] These provisions do not allow communications to and among security holders if the communications may reasonably result in obtaining a proxy unless certain prescribed information contained in a proxy circular is distributed to security holders. Consequently, the provisions have effectively prevented shareholder communications in anticipation of a vote, unless a dissident proxy circular has been prepared.

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[228] The CBCA Amendments were effected by the passage of *An Act to Amend the Canada Business Corporations Act and the Canada Cooperatives Act and to Amend Other Acts in Consequence*, proclaimed in force November 24, 2001 (SI/2001-114) [hereinafter, "Act to Amend the CBCA"].

[229] Kimber Report, para. 6.02.

[230] *Ibid.* para. 6.24.

[231] The Act, s. 85.

[232] The Act, subsections 86(a) and 86(b).

The Act contemplates certain exemptions from the rules relating to proxy solicitation.[234] For example, reporting issuers are exempt from having to comply with Part XIX of the Act if the issuer complies with "substantially similar" laws of the jurisdiction of incorporation.[235] The CBCA and the OBCA contain provisions that are similar in many regards to the Act.

15.2 Recent CBCA Amendments

The CBCA Amendments liberalize the rules relating to proxy solicitation. The basic rule remains that a person shall not solicit proxies unless that person first prepares, files and delivers a proxy circular in the prescribed form.[236] However, under the CBCA Amendments, a "solicitation" does not include:

(a) a public announcement (such as a speech in a public forum or press release)[237] by a shareholder of how the shareholder intends to vote and the reasons for that decision;[238] or

(b) a communication, other than a solicitation by management, that is made to shareholders in any circumstances that may be prescribed.[239]

Among the other CBCA reforms, a dissident shareholder may solicit proxies without preparing and sending a proxy circular to shareholders if the solicitation is, in the prescribed circumstances, conveyed by public broadcast, speech or publication.[240] Solicitations conveyed by these means must contain information regarding the identity of the shareholder, its percentage shareholdings and its interests in the matter being solicited.[241] Before the advertisement or other form of communication is released, it must be delivered only to the Director under the CBCA and the corporation.[242]

The CBCA Amendments are consistent with rules adopted by the SEC in 1992 relating to proxy solicitation. The SEC was concerned that any expression of opinion concerning a public corporation could be viewed as a proxy solicitation. In its view, "the federal proxy rules [had] created unnecessary regulatory impediments to communication among shareholders and others and to the effective use of shareholder voting rights."[243] The SEC specifically highlighted newspaper opinion editorial articles, public speeches and television commentary as communications that could be interpreted as a regulated solicitation.[244]

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[233] The Act, s. 84.

[234] Two exemptions not discussed here are contained in subsection 86(2) and subsection 86(3) of the Act.

[235] The Act, subsection 88(1). The provision states that "[w]here a reporting issuer is complying with the requirements of the laws of the jurisdiction under which it is incorporated, organized or continued and the requirements are substantially similar to the requirements of this Part, the requirements of this Part do not apply."

[236] CBCA, subsection 150(1).

[237] Canada Business Corporations Regulations, 2001, proclaimed in force November 24, 2001 (SOR/2001-512), at s. 61.

[238] Act to Amend the CBCA, subclause 147(b)(v).

[239] *Ibid.* subclause 147(b)(vii).

[240] *Ibid.* subsection 150(1.2) to be added after the current subsection 150(1) and the new subsection 150(1.1).

[241] Canada Business Corporations Regulations, 2001, *supra* note 238 at subsection 63(1).

[242] *Ibid.* subsection 63(2).

[243] SEC, *Regulation of Communications Among Shareholders*, 17 CFR Parts 240 and 249, Release No. 34-31326170, (22 October 1992).

[244] *Ibid.*

The SEC adopted amendments that would eliminate regulatory obstacles that prevented shareholders from exchanging views on management performance and initiatives.

15.3 The Need for Reform in Ontario

The Committee is concerned that the existing proxy solicitation rules in securities legislation are too restrictive in that they may discourage shareholders from communicating with each other. For instance, we note the interpretative difficulties with the definition of "solicitation," which includes communications that are "reasonably calculated to result in the procurement, withholding or revocation of a proxy."[245] The difficult issue is whether communications in advance of an actual solicitation would be considered part of the process of solicitation based on this definition.

The ability of shareholders to communicate with each other is fundamental. As the Ontario Teachers' Pension Plan Board stated in its presentation to the Standing Senate Committee on Banking, Trade and Commerce:

> Shareholders must be informed. They must conduct continual research on the company. They must review policies, prospects and decisions. When questionable decisions are made, they must indicate their concern ... Shareholders must speak with many people in the market. They must speak with each other to learn whether their views are widely shared or are a minority opinion. They must be able to speak with the company as individuals or as a group. When a problem surfaces, they must be able to discuss their concerns; when a corporate proposal is made that demands opposition, they must be able to act. The Canadian proxy rules ... create substantial barriers to this kind of continued, informal communication among shareholders ... The result is detrimental to shareholders, corporations and the integrity of the process itself.[246]

When shareholders communicate with each other, it is important that they disclose information such as their identity and any material interest they have in the issuer. We believe that this information is important in allowing other shareholders as well as management to evaluate the communication and put it in perspective.

We support the CBCA Amendments and recommend that the Commission adopt similar amendments to Part XIX of the Act. We recommend that similar amendments be made to the OBCA so that companies incorporated under the OBCA are subject to the same regime as companies incorporated under the CBCA.

If feasible, we also would support incorporation by reference in the Act of requirements relating to proxy solicitation from other jurisdictions such as the provincial or federal corporate statutes. Subsection 88(1) of the Act provides that an issuer is exempt from Part XIX of the Act if the issuer is complying with "substantially similar" laws contained in the statute of its jurisdiction of incorporation.[247] However, we question whether the CBCA provisions relating to proxy solicitation which came into place under the CBCA Amendments would be considered "substantially similar" to the corresponding requirements in the Act. If not, this would prevent a reporting issuer under the Act from taking advantage of the more liberal CBCA proxy solicitation provisions. If the Act were instead to incorporate by reference the proxy rules of another jurisdiction, rather than enumerating its own rules, then reporting issuers would not be placed in a situation where the corporate and securities laws governing proxy solicitation differ, thereby compromising the issuer's ability to rely on subsection 88(1).

Recommendation:

We support the reforms to the CBCA relating to proxy solicitation. We believe that Part XIX of the Act should be similarly amended to ensure that shareholders are able to communicate with each

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[245] The Act, clause 84(c); CBCA, clause 147(c); OBCA clause 109(c).

[246] The Standing Senate Committee on Banking, Trade and Commerce, "Corporate Governance" (August 1996) online: http://www.parl.gc.ca/english/senate/com-e/bank-e/rep-e/cgo-e.htm at 49-50.

[247] The Act, subsection 88(1).

other in prescribed circumstances without having to file an information circular. We believe that the Commission should co-ordinate with the provincial government so as to ensure that amendments adopted under the OBCA and the Act are uniform. We further recommend that the Commission consider whether it has the authority to incorporate by reference the requirements of another Canadian statute such as the OBCA or CBCA with regard to proxy solicitation, rather than stating the rules explicitly in the Act.

15.4 Shareholder Communications in the Context of a Take-Over Bid

The Committee also examined rules relating to shareholder communication in the context of a take-over bid. In particular, the Committee considered revisions to the proxy solicitation rules adopted by the SEC in 2000.[248] These changes were prompted by an increase in the number of merger and other acquisition transactions involving proxy or consent solicitations. The SEC noted that technological advances have resulted in more and faster communications with security holders and the markets. Thus, in its release, the SEC implemented new rules and amendments that would:

- Relax existing restrictions on oral and written communications with security holders by permitting the dissemination of more information on a timely basis, so long as the written communications are filed on the date of first use;
- Permit more communications before the filing of a registration statement in connection with either a stock tender offer or a stock merger transaction;
- Permit more communications before the filing of a proxy statement (whether or not a business combination transaction is involved); and
- Permit more communications regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.[249]

The Committee considered whether Ontario's take-over bid laws should similarly be revised to permit communications with and among shareholders in less restrictive circumstances. We believe that this is an area that requires further study and we call upon the Commission, together with the other members of the CSA, to undertake this analysis.

Recommendation:

We recommend that the Commission, together with the CSA, undertake further study to determine whether amendments to securities law are necessary with regard to communications with and among shareholders in the context of a take-over bid.

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[248] SEC, *Regulation of Takeovers and Security Holder Communications*, 17 CFR Parts 200, 229, 230, 232, 239 and 240, Release No. 33-7760, 34-420055.

[249] *Ibid.* at 61408-61409.

Chapter 16: Take-Over Bid Regulation

The Committee received very few submissions relating to take-over bid regulation.[250] This may be in part because most CSA jurisdictions, including Ontario, have recently enacted legislation implementing the recommendations of the Zimmerman Committee.[251]

16.1 Arrangements/Take-Over Bids

The Committee considered whether the take-over bid provisions should be extended to transactions that are not structured as bids but that achieve the same result, such as arrangements that are intended to acquire control of a company. The CVMQ published a notice for comment on this subject in 2001.[252]

It may seem logical to compel parties completing an arrangement to comply with rules governing take-over bids when arrangements may lead to substantive results similar to those of take-over bids. However, we note that arrangements attract a different set of safeguards from those associated with take-over bids. For instance, in the take-over bid context, the bidder deals directly with the target shareholders and rules such as the identical consideration provision prevent the bidder from discriminating among them. If a transaction is structured as an amalgamation or a plan of arrangement, the target company's board negotiates and approves the transaction. Shareholders must approve the arrangement by a two-thirds majority and separate class votes are available in many instances. A plan of arrangement is also subject to court approval. The two types of transactions need not be regulated in an identical manner. We believe that each transaction, and the legislative means to achieve the transaction, must be fair to all interested parties. We believe that investor protection concerns must be balanced with the public policy objective of retaining a flexible regulatory regime which allows parties the freedom to structure transactions to achieve their business objectives.

The issue to be addressed from a public policy perspective is whether shareholders have the benefit of procedural and substantive safeguards that will give them the confidence that they will be treated fairly when a third party wishes to acquire their shares. Whether the procedural safeguards currently in place for plans of arrangements are sufficient (i.e., board approval, disclosure requirements and shareholder votes, and court approval) may be worth considering.

Recommendation:

Nothing has come to our attention that would support the need to regulate arrangements and take-over bids in an identical fashion. We believe that, as a matter of public policy, parties to commercial transactions should have the freedom to structure transactions to achieve their business purposes so long as these transactions, and the legislation that governs these transactions, are fair to all interested parties. The Committee notes that it is especially important to harmonize take-over bid regulation across the country and encourages the CSA to adopt a harmonized approach with respect to these issues.

16.2 Mini-Tenders

Mini-tenders are widely disseminated offers to acquire less than 20 per cent of the outstanding securities of a class typically at a discount to the current market price of such shares. Because they are offers for less than 20 per cent, they fall outside of the provisions of Part XX of the Act, which impose rules governing the conduct of take-over bids. The Committee discussed whether "mini-tenders" should be subject to regulation by the Commission.

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[250] The Committee received comment letters from the Take-over Bid Team dated August 11, 2000, and from James Turner.

[251] The Zimmerman Committee consisted of members of the IDA and was formed to review take-over bid time limits. The Zimmerman Committee issued a report in 1996 that recommended a number of changes in the regulation of take-over bids.

[252] CVMQ, Bulletin Hebdomadaire: 2001-06-29, vol. xxxii no. 26.

In 1999, CSA staff issued a notice outlining its concerns and recommendations relating to mini-tenders.[253] The Mini-Tender Notice focussed on potentially abusive mini-tenders where investors are unaware that they are tendering to a below market offer that is not regulated under provincial securities legislation. Staff recommended that mini-tenders should include information such as: the principal market for the securities, a warning that the offering price is below the current market price, and a statement that people tendering to the offer should consult their financial advisers. We understand that mini-tenders continue to be made despite the existence of the Mini-Tender Notice.

We believe that the Commission's public interest powers under section 127 of the Act enable the Commission to address fraudulent or manipulative conduct in the mini-tender situation. We recommend that enforcement proceedings be taken before the Commission in cases that involve mini-tenders that are conducted in an abusive, misleading or deceptive manner. In addition, we note that, in Chapter 22, we recommend that the Act be amended by adding a provision that prohibits market manipulation and fraudulent activity. We believe that such a provision would provide an additional legislative basis for the Commission to regulate mini-tenders.

In the event that the mini-tender situation becomes so prevalent that a different regulatory response is necessary, then consideration should be given to whether a rule initiative would be warranted in this area to establish the disclosure requirements and other procedural protections that should apply to mini-tenders. We welcome any additional comments on this issue.

16.3 Issues for Further Study

(a) Partial Bids

A partial bid is a take-over bid made by an offeror to acquire some, but not all, of the outstanding shares of the target corporation. The purpose of the partial bid is to allow the bidder to acquire a substantial enough position in the target so that the bidder may exercise *de facto* control or significant influence over the target, without incurring the cost of purchasing all the shares in the target which it does not own.

There is no prohibition in Ontario securities law, or the securities legislation of the other provinces and territories in Canada, against partial take-over bids. To the extent a partial bid constitutes a take-over bid for purposes of Part XX of the Act, it must be conducted in accordance with the take-over bid regime set out in Part XX; however, nothing in Part XX requires that any proposed take-over bid made must be for all of the issued and outstanding shares not then owned by the bidder. In this respect, Canadian regulation of take-over bids is similar to the approach in the United States, where partial bids are also permitted. In contrast, in the United Kingdom the legislation provides that the Panel on Take-overs and Mergers must approve any partial bid, and if an offer is made that will result in the offeror owning more than 30 per cent of the issued and outstanding shares of the target, then the offer must be conditional on receiving the approval of shareholders holding more than 50 per cent of the target's voting securities not held by the offeror.

Partial bids are considered by some to be coercive. After the completion of the partial bid, there is less liquidity for trading in the shares since there are fewer shares still trading in the public market. Further, it is unlikely that another bidder will make an offer to acquire the remaining shares in the company given the ownership position of the bidder. Finally, in situations where the partial bid results in the offeror owning more than 50 per cent of the shares of the target, the remaining shares will constitute a minority position in the company. For these reasons, critics of partial bids are concerned that shareholders may feel compelled to tender to a partial bid in order to realize at least some premium, and accordingly, they are not able to react to the bid on its merits.[254]

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[253] CSA Staff Notice 61-301, "Staff Guidance on the Practice of 'Mini-Tenders'" (December, 1999) (the "Mini-Tender Notice").

On the other hand, others consider partial bids to be acceptable take-over bid structures. The structure is permitted under Canadian securities legislation. Further, it is a structure that facilitates change of control transactions. Shareholders are competent to make their own decisions as to whether to tender to a bid, partial or otherwise. Facilitating change of control transactions, where shareholders are able to influence the outcome of the transaction by deciding whether to tender or not, is important.

The Commission has had occasion to consider partial bids in the context of certain poison pill hearings. In *In the Matter of Ivanhoe III Inc. and Cambridge Shopping Centres Limited*,[255] the Commission acknowledged that partial bids could be coercive and allowed the poison pill (which Cambridge had put in place in the face of a partial bid), additional time to operate. Two years later, in *In the Matter of Chapters Inc. and Trilogy Retail Enterprises L.P.*,[256] the Commission considered whether a pill put into place by Chapters in the face of a partial bid by Trilogy could stay in place until a subsequent bid for all the outstanding shares, made by a white knight, could be prepared and mailed to shareholders of Chapters. In its decision, the Commission qualified its decision in *Ivanhoe* noting that, while in that case it had agreed "in general" with the view that partial bids are coercive, "Chapters cannot simply rely on Ivanhoe as establishing the principle that partial bids are *ipso facto* coercive." In the Chapters situation, the Commission was not persuaded that the bid would result in a less liquid market or less valuable minority interest.

The decisions of the Commission in *Ivanhoe* and in *Chapters* suggest a willingness on the part of the regulator to continue to allow partial bids, but to deal with allegations of coercion in the context of such bids on a case-by-case basis. We invite comment on whether there should be a change in regulatory approach in Ontario to partial take-over bids, and if so, what the new regulatory response should be.

(b) Defensive Tactics

The most common defensive tactic is the poison pill. Poison pills are sometimes adopted in the face of a take-over bid, or may be put in place when there is no bid pending. Poison pills are rarely, if ever, triggered. They are a device for negotiation and for extending the time period available to the target's board to seek alternative offers. In the context of a hostile bid, the target and the offeror are unlikely to agree as to when the pill will be terminated and the offer allowed to proceed.

Frequently, Commission hearings are convened in the context of hostile take-over bids so that the Commission can consider whether it is "time for the pill to go" and thereby permit the bid to proceed. These hearings consume considerable resources and entail significant cost. We note that guidance has been generated through decisions rendered in the context of specific poison pill hearings. We recognize that each bid is fact specific, and while there appears to have been a decline recently in the number of poison pill hearings, we believe that an overall policy derived from the guidance in these decisions could be useful in obviating the need for hearings in the future to determine when it is time for the pill to go.

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[254] See *In the Matter of Ivanhoe III Inc. and Cambridge Shopping Centres Limited* (1999), 22 OSCB 1327 at 1329.

[255] *Ibid.*

[256] (2001), 24 OSCB 1064 and 1663.

Recommendation:

The Commission should consider preparing a policy statement setting out guidance as to when in a take-over bid a poison pill must be terminated.

(c) Convertible Securities

The Committee also examined the application of formal take-over bid rules to convertible securities. The anti-avoidance provision contained in section 92 of the Act provides that an offer to acquire "shall be construed to include a direct or indirect offer to acquire or the direct or indirect acquisition or ownership of securities...." In interpreting this provision, it is unclear when a purchase of convertible debentures constitutes the purchase of the underlying shares as opposed to the debenture. This issue has implications for the way in which other provisions of Part XX of the Act are interpreted and applied. For instance, if an offer to acquire convertible securities is an offer to acquire the underlying shares, must the price offered for convertible securities be identical to the price offered for common shares in the direct offer made to common shareholders?[257]

We note that there are opposing views within the legal profession regarding the interpretation of section 92. One view is that one must assess the true intention behind an offeror's purchase of the convertible securities. If the intention is to acquire the underlying shares, then the offer for the convertible securities will be characterized as an offer for the underlying shares. There is no need to regulate all acquisitions of convertible debt as take-over bids but, rather, to have the Commission exercise its public interest jurisdiction in the rare, abusive situations.[258] Others find the subjective test unacceptable and believe that further clarity is required as to when an offer for convertible debt is an offer for underlying shares.

We are inclined to the view that providing absolute certainty in this area ultimately would not be constructive. We believe that, if anything is warranted, it would be more in the nature of a policy statement providing guidance on the interpretation of section 92. We welcome input on whether a rule or policy guidance to deal with the matter of convertible securities is desirable and, if so, which approach is preferable.

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[257] See William Ainley, *Legal Developments in Canadian M&A Practice* (Toronto: Insight Information Co., 2000).

[258] See Comment Letter of James Turner.

Chapter 17: Mutual Fund Governance

In considering whether any changes are needed to the regulatory regime governing mutual funds, we focussed primarily on fund governance.

17.1 Background

A mutual fund is an investment vehicle for retail investors. The assets of the investors are pooled in one portfolio and are managed by professional money managers.

Mutual funds are organized and promoted by a company which is typically referred to as the "mutual fund manager" or "manager." In establishing a mutual fund, the mutual fund manager organizes the fund; arranges for the offering documentation of the fund to be prepared, filed and cleared with securities regulatory authorities in every province in which the fund will be offered for sale to the retail public; and takes on the management, administrative and investment management responsibilities associated with operating the fund on an ongoing basis. The manager may provide these services directly or may subcontract with third parties to provide these services to the fund on its behalf. The manager is paid a fee by the mutual fund for providing these services.

Conflict issues in the mutual fund industry may arise because the manager is an entity separate from the mutual fund itself and is in business to make a profit for its shareholders from its management function. This may place the manager in a conflict of interest when making decisions as to the management of the fund as some decisions that are profitable for the manager and its shareholders may not be in the best interests of investors in the fund.[259] The conflicts of interest are compounded when managers are not managers of one fund only but of a number of funds.[260] The questions then become, whose job is it to safeguard the interests of the mutual fund, and can we reasonably expect the manager to fulfil that role?

There is at this time no legislative requirement to ensure that there is a player in the mutual fund family whose role it is to ensure that the interests of the unitholders are taken into account by the manager. A mutual fund investor has no remedy if he or she is displeased with the performance of the management company, other than to exit the mutual fund. The decision to exit will generally attract negative economic consequences.

Mutual fund governance has been the subject of a number of studies in Canada in the past 35 years. While all of these reports have recognized the importance of independent oversight, they have reached different conclusions regarding the need to legislatively mandate this requirement.

The *Report of the Canadian Committee on Mutual Funds and Investment Contracts* (the "1969 Report") noted there are certain types of risks that investors in mutual funds would not generally be assumed to have accepted in making their investment decisions, including risks arising from the lack of independent oversight. The 1969 Report continued:

> The best protection against the types of risks here being considered would be an arrangement whereby the management company and the distribution company were subjected to continuing independent scrutiny over their operations. This scrutiny might be provided by the mutual fund investors, or by a surrogate acting on their behalf; what is essential is that the procedure used be effective but not

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[259] For example, in determining the allocation of expenses as between the manager and a fund, the manager may be tempted to characterize as fund expenses certain items that are more appropriately characterized as expenses of the manager carrying out its management obligations to the fund. Or, if a fund is performing poorly, the portfolio manager should perhaps be terminated but if the portfolio manager is an affiliate of the manager, and is bringing additional fees into the management complex for its services, the manager may be disinclined to terminate the portfolio manager.

[260] For example, a manager may choose to allocate more resources to funds with better performance records and, in effect, orphan its lesser-performing funds.

> interfere unduly with the freedom of management to make investment decisions.[261]

However, the 1969 Report stopped short of recommending a statutory requirement for each mutual fund to have a board of directors or equivalent body or that a specified percentage of the members of such bodies be independent of management, although it suggested there could be voluntary adoption of such a structure.

A report prepared for the Department of Consumer and Corporate Affairs in 1974 also considered whether a system of fund governance was necessary in the Canadian mutual fund industry, but concluded that:

> Except in special circumstances the mutual fund should not be treated as a separate entity from its investment manager, requiring a separate board of directors.[262]

More recent reports strongly support the adoption of a fund governance regime in Canada. In *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Mutual Funds in Canada* (the "Stromberg Report"), Commissioner Stromberg stated that:

> There is something inherently wrong with a structure that permits all the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that are in effect unilaterally imposed without there being some degree of review by unrelated persons who are considering the merits solely from the perspective of the best interests of the investment fund and its investors.
>
> In the current structure, there is no one whose sole responsibility it is to look out for the interests of investors and it is not clear that the primary obligation of the investment fund manager is to put the interests of its sponsored investment funds ahead of all other interests. ... [I]nvestment fund organizations are focussed on gaining market share and benefiting their shareholders and other stakeholders. Their focus is not exclusively on their obligations to their sponsored investment funds.[263]

Consequently, the Stromberg Report contained a recommendation that each investment fund should be required to have an independent board. Commissioner Stromberg stated:

> I believe that there is justification for this [recommendation] by reason of the unique relationship that exists between the investment fund and its manager. This relationship gives rise to conflict of interest situations that occur on a continuing basis in the ordinary course of business and otherwise. In view of the fact that it is impractical for each situation involving a conflict of interest to be referred to security holders for approval, it is essential that there be an independent body whose sole focus is the interests of the investment fund and its security holders.[264]

The Investment Funds Institute of Canada and the Commission jointly established a steering group (the "Steering Group") to review and respond to the Stromberg Report. In its report, the Steering Group agreed in principle with the recommendations of Commissioner Stromberg, but ultimately recommended that each fund family, rather than each fund, should have a board of at least five members, the majority of whom are independent of the manager, and an audit committee comprised entirely of independent members of the board.[265] Further, the Steering Group recommended that the fund family board should not have the power to terminate the manager.

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[261] *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study* (Ottawa: Queen's Printer, 1969) at 151.

[262] J.C. Baillie and W.M.H. Grover, *Proposals for a Mutual Fund Law for Canada*, vols. I & II, Consumer and Corporate Affairs (Ottawa: Information Canada, 1974) [hereinafter the 1974 Proposals], in Vol. 1 at 3-4.

[263] G. Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada*, prepared for the CSA (Toronto: Ontario Securities Commission, January 1995) at 147-148.

[264] *Ibid.* at 152.

[265] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, prepared for the CSA (Toronto: Queen's Printer, November 1996) at 50-51 [hereinafter the Steering Group Report].

In Canada, the matter of mutual fund governance has been most recently considered in a report produced for the CSA by Stephen Erlichman in August 2000, and in a Concept Proposal issued by the CSA on March 1, 2002.[266] The Erlichman Report provides an overview and analysis of the historical consideration of mutual fund governance in Canada and a review of the governance structures which could be adopted by the mutual fund industry in Canada. The Erlichman Report recommends that each mutual fund family should be required to establish a governance regime that has a governing body independent from the manager of the mutual fund. The Report does not insist upon a particular governance structure. Rather, it states that if regulators choose to mandate one specific form of fund governance, then each mutual fund should have a "corporate style" board (of governors, trustees or directors, as the case may be), which should be comprised of at least a majority of independent directors. The sole interest of this governance board would be to focus on the best interests of the mutual fund and its unitholders.[267]

In the Concept Proposal, the CSA outlines its vision for regulating the mutual fund industry in Canada in the future, including its proposals to improve mutual fund governance. The Concept Proposal recommends requiring a governance agency which is independent of the mutual fund manager that will supervise the manager's management of its funds and will act to ensure the funds are managed in the best interests of investors. The governance agency will be vested with specific responsibilities including: meeting regularly with management; overseeing and monitoring the manager's compliance with policies and procedures; acting as an audit committee; and monitoring that funds are managed in accordance with their stated investment objectives and strategies. The Concept Proposal is open to comments until June 7, 2002.

In the United States, the *Investment Company Act of 1940* (the "1940 Act") has contained long-standing provisions requiring investment companies to have boards of directors including independent directors. On January 2, 2001, the SEC adopted rules and rule amendments regarding investment company fund governance and the role of independent directors of investment companies. The effect of the rules and rule amendments is to require a majority of the board of directors to be independent of the manager if the investment company wishes to rely on exemptive rules contained in the 1940 Act to engage in certain self-dealing and conflict of interest behaviour. Furthermore, the independent directors must select and nominate any other independent directors and their legal counsel, who must also be independent of the manager.

The Committee received a number of submissions on this matter. The majority of commenters were in principle supportive of a statutory requirement for independent oversight of mutual funds.[268] One commenter was opposed to an independent oversight body.[269] This commenter contested the view that adopting a governance mechanism for mutual funds in Canada is necessary or desirable. This commenter's position is based on his view that there is no evidence of abuse in the mutual fund industry with which an independent governance body would be qualified to deal.

17.2 The Case for an Independent Mutual Fund Governance Requirement

Given that most major jurisdictions other than Canada have some form of a mutual fund governance requirement, the Committee considered whether there is anything particular to the mutual fund industry in Canada that justifies the continued absence of such a requirement.

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[266] Stephen Erlichman, *Making it Mutual: Aligning the Interests of Investors and Managers*, prepared for the CSA, (June 2000) [hereinafter the Erlichman Report]; CSA Concept Proposal 81-402, Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers (2002), 25 OSCB 1227 [hereinafter, the Concept Proposal].

[267] *Ibid.* at 8-11.

[268] See comment letters of the Canadian Association of Insurance and Financial Advisers, Simon Romano and Glorianne Stromberg.

[269] See comment letter of Larry Schwartz.

In considering the question of mutual fund governance, the Committee was guided by our principle that there must be a compelling public policy reason to introduce regulation. The fundamental reason for requiring mutual fund governance in Canada is that the structure of the fund industry is by definition conflicted and there is no one whose sole responsibility is to protect the interests of unitholders. The fund manager is responsible for establishing the fund, managing the fund, retaining the investment manager for the fund, setting fees paid to the investment manager and the manager, and settling all expenses to be charged to the fund. At the same time, the management company is in business to do all of this in a manner most profitable to the shareholders of the management company. That the profit may be enhanced by increasing fees or expenses to the mutual fund, and therefore its unitholders, is disciplined only by market forces. An efficient market would dictate that a mutual fund with high fees and expenses would be less likely to be purchased. Undoubtedly, many mutual fund managers also see the correlation between success by the funds they manage and success for themselves. Nevertheless, the reality of the Canadian mutual fund industry is that manufacturers of mutual funds are primarily in the business of marketing their mutual funds and a number of the marketing techniques employed encourage investors and their advisers to purchase funds that may have higher fees and expenses than competing mutual funds, either because of successful advertising or because of favourable compensation structures for advisers who recommend the mutual funds.

Certain fund managers also support fund governance because National Instrument 81-102, which governs mutual fund structures and operations in Canada, as well as Canadian securities legislation, prohibits mutual funds from engaging in certain self-dealing activities. These industry participants have suggested that the presence of an independent board would remove or at least lessen the need for these prohibitions in the governing legislation as the independent board could determine whether any particular transaction or arrangement would compromise the interests of the unitholders of the fund.

We believe that the introduction of a system of mutual fund governance in Canada, so as to provide oversight of the functioning of the mutual fund which is both independent of the management company and focussed exclusively on the best interests of the unitholders, is overdue. We acknowledge that there have been virtually no publicly reported cases of abuse in the mutual fund industry arising from self-dealing or conflict of interest allegations. However, the absence of publicly reported cases of abuse does not mean that there are no problems, whether perceived or real. Currently there is no constituency to exercise oversight on behalf of mutual fund investors and to raise issues of concern to them. We understand that a large number of mutual fund management companies support the principle of fund governance. It is likely that implementing specific requirements for oversight of the operation of mutual funds will further assist managers in establishing and maintaining appropriate policies and standards of conduct to govern themselves and the funds they manage.

We believe that the presence of experienced, independent people on a board (or other equivalent body) of a mutual fund will improve the process by which decisions are made and, therefore, the results for unitholders. A strong, independent governance body is a discipline on the manager and on management of the mutual fund; for example, some business plans, cost allocations or marketing programs will not receive the approval of a strong, independent governance body, which will in turn cause management to develop alternative plans, allocations or programs. Independent directors can also scrutinize management performance and fees. Such results can only be of benefit to the entire industry. The existence of a governance body to which management is accountable would also cause management to establish written policies and procedures where informal practices had existed, and to submit them to third-party scrutiny.

The Committee is aware, however, that the implementation of a system of mutual fund governance will be difficult in Canada. There will be costs involved in attracting and retaining directors for each mutual fund or family of mutual funds. These costs will likely be borne by mutual funds and, by implication, their investors. However, the existence of an independent governance body will help to protect the interests of unitholders so that the cost of establishing and maintaining the governance body should be recouped by its vigilance on behalf of the unitholders.

The Committee also considered whether the independent governance body should have the right to terminate the manager for any reason. We are mindful of the fact that the manager took the initiative to found, organize and sponsor the mutual fund and that, if the manager is terminated for any reason, this could be seen as an expropriation of the manager's property interest in the fund. On the other hand, the moment the manager offers the mutual fund for sale to the public, the unitholders become stakeholders and the manager assumes an obligation to them. Indeed, there is a fiduciary relationship between the mutual fund manager and the investors. Furthermore, the independent governance body's sole mandate will be to act in the best interests of the unitholders of the fund. Failure to empower the independent governance body to terminate the manager for appropriate cause will create serious difficulties for it in fulfilling its obligations to the unitholders.

We therefore believe that the independent governance body should have the right to terminate the manager. The governance body should have the right to do so at any time when, in the reasonable opinion of the independent directors: (i) there is cause (including poor performance of the fund); or (ii) when the interests of the manager have been placed ahead of the interests of the unitholders through self-dealing, conflict of interest transactions, or breach of fiduciary obligations.

Recommendation:

The Commission and the CSA should introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body. This body should have the right to terminate the mutual fund manager when, in the reasonable opinion of the independent directors, there is cause, including poor performance of the fund, or where the manager has placed its interests ahead of those of unitholders of a mutual fund through self-dealing, conflict of interest transactions or breach of its fiduciary obligations.

17.3 Recruiting Qualified Mutual Fund Directors

A second and critical concern with establishing a fund governance system is the ability to find a sufficient number of qualified people to serve as directors. There are currently in excess of 1,700 mutual funds and 70 mutual fund management companies in Canada. The Committee is concerned that, unless a new approach to selecting, recruiting and nominating directors is adopted, the Canadian marketplace will be strained to field the appropriate number of qualified directors.

The current process for identifying and recruiting public company directors in Canada relies extensively on a network of experienced directors who are familiar with other directors and their capabilities, and who rely on this information in recommending new directors. This process is reinforced by the reluctance both of recruiters to look at individuals below the level of CEO of companies, and of certain companies to allow employees other than the CEO to act as directors. While the Committee refrains from commenting generally on these practices, we do believe that the introduction of a requirement for mutual fund governance bodies provides an excellent opportunity for the introduction of new approaches to recruiting directors.

We believe that there is a sufficient pool of talent available in Canada to support a new governance regime for mutual funds, but that pool of talent will only be accessed if the traditional process for recruiting and nominating directors is modified. We believe that mutual funds and their nominating committees should expand the pool of talent they will consider to include individuals below the ranks of CEOs, as well as retired professionals. Non-profit organizations such as universities, business schools and hospital administrations should also be viewed as potential sources of directors.

In addition to finding and attracting potential directors, mutual funds will need to ensure that the majority of directors are completely independent from the management company. This issue presents challenges since the management company will nominate the first directors. If the first and subsequent directors are not independent, then effective governance may be compromised. Mutual fund governance rules will need to set out a test or definition of independence.

Recommendation:

We recommend that the process by which potential directors of mutual fund governance bodies are identified and nominated be expanded so as to include a broader range of potential directors. We further recommend that the majority of directors be independent of the management company.

17.4 How the Independent Governance Body Will Look

The Committee identified a number of elements that should comprise a mutual fund governance model:

- The governance body should be independent from the manager and should have a mandate to act only in the best interests of the fund and its investors.
- The majority of directors should be independent of the management company but should not be the same as any independent directors of the management company.
- The independent governance body should have the ability to fix its own fees based on such advice as it may seek to rely on, including the advice of an independent compensation adviser. The members of the governance body should disclose annually the fees they receive from that fund and all other funds in the same family.
- There should be a cap on the number of funds for which any one independent governance body is responsible. The number of governance bodies that is appropriate for each family of mutual funds will depend upon a number of factors particular to that family of funds. We do not want directors to be overburdened in respect of the number of funds for which they will be responsible. We do not propose that the regulator specify a definitive limit on the number of mutual funds that may be overseen by any one governance agency. However, we are concerned that this determination should not be made solely by the manager, given its conflict. It may be appropriate for the independent mutual fund governance body to decide how many mutual funds it should be responsible for overseeing. We invite comments on this question.
- Members of the independent governance body should have the right to retain counsel independent of counsel to the fund manager and should have the right to retain other independent advisers as well.
- The independent governance body should review the performance of the manager on a regular basis.
- The independent governance body should have the right to terminate the mutual fund manager in circumstances where, in the reasonable opinion of the independent directors, there is cause (including poor performance of the fund) or where the mutual fund manager has placed its interests ahead of those of the mutual fund unitholders through self-dealing, conflict of interest transactions, or breach of fiduciary obligations (see discussion above in section 17.2).
- The names and contact information of the directors should be published annually and otherwise made available to unitholders so that unitholders have access to those who are acting in their best interests.

Recommendation:

The mutual fund governance body should have certain characteristics, including: independence from the manager; a majority of independent directors; the right to retain counsel and other independent advisers; and the right to set its compensation and establish

the obligation of each member to disclose annually all fees received from the fund and all affiliated funds.

17.5 Functions of the Governance Body

We also considered what the responsibilities of a governance body should be. While this list is not exhaustive, we believe the body should have responsibilities similar to those of a corporate board, including:

- overseeing the establishment and implementation of policies related to matters material to investors and relating to conflict of interest matters such as related party transactions, pricing, brokerage allocation and soft dollars;
- reviewing compliance with such policies;
- monitoring fund performance;
- monitoring fees and expenses and their allocation;
- ensuring compliance with investment goals and strategies;
- reviewing the appointment of the fund's auditor, and considering whether the auditor should be separate from the auditor of the management company;
- meeting with the fund's auditor, which should report to the governance body, not the manager or management company;
- approving material contracts; and
- approving fundamental changes to the fund or its investment objectives.

Unlike the new changes to the U.S. legislation, which mandate a majority of independent directors only if mutual fund companies want to continue to access certain exemptions under the self-dealing rules of the 1940 Act, we believe that these rules should apply to all mutual fund organizations in Canada.

Recommendation:

We believe that it is important to identify certain fundamental responsibilities of the mutual fund governance body. We believe these responsibilities should include, at a minimum, overseeing the establishment and implementation of policies related to conflict of interest issues; monitoring fund performance, fees, expenses and their allocation; ensuring compliance with investment goals and strategies; reviewing the appointment of the auditor; and approving changes to investment goals and strategies and approval of material contracts.

17.6 Should There Be Registration of Mutual Fund Managers?

The Committee also considered whether mutual fund managers should be registered or otherwise regulated. Currently managers are not required to be registered to carry on business as a mutual fund manager. A number of the past reports on mutual fund governance have recommended that fund managers be registered with the securities regulatory authorities.[270] The rationale for this recommendation is that managers of mutual funds play a pivotal role in establishing, promoting and running a mutual fund. Further, because of the range of services provided to a fund by a manager, or overseen by a manager, an investor could risk impairment to, or loss in value of, his or her investment if a manager failed to discharge its obligations fully, in a timely manner, and in a manner free from potential conflicts of interest.

The Committee received only two comments on this issue. Both commenters felt that registration of mutual fund managers is not necessary, primarily because the function performed by them is "basically administrative in nature"[271] or because "the costs would appear to outweigh the benefits, given that the fund itself and its portfolio manager are already regulated."[272]

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[270] Including the 1969 Report, the 1974 Proposals, the Stromberg Report and the Steering Group Report.

[271] See comment letter of the Canadian Bankers Association.

[272] See comment letter of Simon Romano.

The Committee believes that, while the manager's role is primarily operational in nature, the functions it performs on behalf of a fund and its investors are integral to the proper functioning of a fund. Further, independent oversight of the manager also plays a significant role. Independent oversight of the capital adequacy of the manager, the proficiency of its personnel to perform or oversee the performance of all the management functions for which it is responsible, and the standards of business conduct employed by the manager in discharging its obligations to each fund will enhance the integrity of the mutual fund industry in Canada.

In our view, independent oversight can be achieved in one of two ways. Managers could be required to be registered with securities regulatory authorities in order to be eligible to carry on business as a manager. The registration requirements to be met would include minimum capital requirements, insurance requirements, proficiency requirements for personnel of the manager, and requirements relating to standards of business conduct. Alternatively, oversight of the manager's capital adequacy, personnel proficiency and standards of business practice could be vested in the independent governance body. If oversight of the manager resides with the governance body, then requirements which are more suitable to a particular fund company can be crafted. On the other hand, governance bodies may feel it stretches the limits of their mandate to determine the appropriate levels for capital adequacy, proficiency and business standards and would prefer to leave these matters to the discretion of regulators.

We believe that some form of independent oversight of mutual fund managers is appropriate. However, we also believe that additional regulation should not be imposed unless it is justified. We believe that independent oversight of fund managers by the governance body should be sufficient to ensure the capability and capacity of managers to conduct their business in accordance with sound business practices. Requiring mutual fund managers to be registered will impose an administrative burden and a cost on the mutual fund industry. We further note that mutual fund managers fall within the definition of "market participant" so that the Commission already has the jurisdiction to impose sanctions against them if it is deemed to be in the public interest to do so, in accordance with section 127 of the Act. In addition, we have recommended in Chapter 20 that the sanctions available to the Commission under section 127 be expanded to include the ability to order that a person or company be prohibited from becoming or acting as a mutual fund manager or as a director or officer of a mutual fund manager. These additional sanctions would be available even if the manager is not required to be registered.

Recommendation:

Mutual fund managers should be subject to independent oversight of their capital adequacy, personnel proficiency and standards of business practice. We believe that this oversight can be conducted by the independent governance body.

17.7 Rulemaking Authority

As a final matter, we considered whether there is sufficient authority under the Act for the Commission to regulate in respect of fund governance. Subsection 143(31) of the Act states that the Commission may make rules "regulating mutual funds or non-redeemable investment funds and the distribution and trading of the securities of the funds" and enumerates 12 examples of the type of regulation in which the Commission may engage. In the event that the language of subsection 143(31) is not sufficiently broad to cover the mutual fund governance regime we contemplate, then we would support an amendment to confer upon the Commission the necessary authority to address mutual fund governance reform through rulemaking.

Recommendation:

Subsection 143(31) of the Act should be amended, as required, to give the Commission the necessary authority to address mutual fund governance reform through its rulemaking power.

PART 6
ENFORCEMENT

We considered whether the Commission should have any enforcement powers in addition to those currently in the Act. In particular, we asked whether the Commission should have the power to levy administrative fines and whether the range of public interest orders that the Commission can make should be expanded to include some of the orders that a court can make under section 128 of the Act. We considered these issues in the context of the following framework:

- What New Powers Should the Commission Have?
- Which Existing Powers of the Commission Should Be Broader?
- Which Existing Powers of the Court Should Be Expanded?
- Other Enforcement Matters: Confidentiality of Investigations, Fraud and Market Manipulation, and Insider Trading

Chapter 18: Overview

18.1 Introduction

As noted in a recent decision of the Ontario Court of Appeal,[273] the variety of enforcement methods in the Act provides the Commission with a range of remedial options to assist it in carrying out its statutory mandate.

There are three methods through which the Commission may exercise its enforcement powers:

- prosecution of offences under section 122 of the Act;
- exercise of its public interest jurisdiction under section 127 of the Act; and
- application to the court for a declaration of non-compliance and a further order (or orders) of the court under section 128 of the Act.

Section 127 is the most common method by which the Commission exercises its enforcement powers, and it provides the Commission with a "very wide" discretion to intervene in activities related to the Ontario capital markets when it is in the public interest to do so.[274]

In considering the enforcement-related matters raised in our Issues List and making our recommendations, the Committee has been guided by the following basic principles:

- **Primary Purpose of Enforcement Powers:** As a regulator with a public interest jurisdiction, the Commission exercises its enforcement powers for the primary purposes of providing protection to investors, preventing future harm, and ensuring fair and efficient capital markets and confidence in those markets.
- **Meaningful Powers:** It is critical to the fulfilment of its mandate that the Commission be perceived as having meaningful powers that it is prepared to exercise in appropriate cases.
- **Deterrence:** The purpose of an order under section 127 of the Act is "to restrain future conduct that is likely to be prejudicial to the

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[273] *Wilder* v. *Ontario Securities Commission* (2001), 53 O.R. (3d) 519.

[274] *Committee for the Equal Treatment of Asbestos Minority Shareholders* v. *Ontario (Securities Commission)*, [2001] 2 S.C.R. 132 at para. 39 [hereinafter *Asbestos*].

public interest in fair and efficient capital markets".[275]

- **Flexibility:** The Commission should have available to it a sufficiently broad range of remedies so that it has the flexibility to design the appropriate remedy to address the particular circumstances of each case.
- **Inter-Jurisdictional Co-operation:** The increasing globalization of the capital markets and rapid development of technology have resulted in a borderless marketplace. It is essential for securities and other regulatory authorities to co-operate in their information gathering, investigations and enforcement efforts.[276] Such co-operation is facilitated where the Commission has effective and meaningful enforcement powers, having regard to national and international standards.

The Committee has also considered the enforcement powers of securities regulators in other provinces and in jurisdictions outside of Canada and the extent to which the Commission's enforcement powers need to be brought up to date.[277]

18.2 Background: The 1990 Proposals

In 1988, practical and legal deficiencies in the enforcement provisions of the Act prompted a full review of those provisions by the Commission. The proposed amendments to the Act resulting from this review were published for comment in 1990 (the "1990 Proposals").[278] This was the first set of proposed revisions to the Commission's enforcement powers in 20 years, and was a response to considerable changes in the capital markets that had taken place in that intervening period. The 1990 Proposals also reflected a move to greater harmonization with investigation and enforcement powers of regulators in other jurisdictions, including British Columbia, Alberta and the United States.[279]

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[275] *Asbestos, supra* note 274, per Iacobucci, J, at para. 43.

[276] *Global Securities Corp. v. British Columbia (Securities Commission)*, [2000] 1 S.C.R. 494.

[277] The Commission's general enforcement powers under the Act are similar to those of the three other major securities commissions in Canada, being the Alberta, British Columbia and Quebec Securities Commissions, but in some important respects, they are not as extensive. In formulating our recommendations, the Committee considered, on a comparative basis, those areas in which one or more of these agencies have powers which the Commission lacks. The Committee also considered the enforcement powers of securities regulators in the United States, the United Kingdom and Australia.

[278] *Proposals for Amendments to the Securities Act in the Areas of Investigations, Enforcement and Remedies*, (1990), 13 OSCB 405. The proposals relating to the Commission's enforcement powers included the following:

a) Add a requirement that the Commission apply forthwith to the court to continue a freeze order made by the Commission.

b) Expand the remedial powers of the Commission to provide a wider range of disciplinary and compensatory powers, including powers to order the following: compliance with the Act, regulations and policy statements; compliance with by-laws, rules, regulations, procedures, practices and directives of a self-regulatory organization; amendment to or cessation in the distribution of a wide range of disclosure materials; private or public reprimand of a person (including professional advisers) for misconduct in the marketplace; prohibition of a person (including a professional adviser) who engages in misconduct in the marketplace from holding office in or being a director of or being employed or retained by or in any other way associated with any registrant or reporting issuer; disgorgement; payment of costs associated with an investigation or proceeding before the Commission.

c) Give the Commission broad power to apply to the court for a declaration of non-compliance and give the court power to order compliance and a wide range of other remedies including rescission, compensation for damages, payment of punitive damages, appointment or removal of directors, issuance, cancellation, purchase, exchange or disposition of a security, and prohibition of voting or exchange of any rights attaching to a security.

d) Extend responsibility for a breach of the Act to reach beyond officers and directors, to any person (including a professional adviser) who authorizes, counsels or participates in a breach of the Act, the regulations or the policy statements.

Following the publication for comment of these proposals, the Commission published a draft of the specific proposed changes to the Act ((1991), 14 OSCB 1907). In addition to the matters listed above, this draft included certain additional proposed enforcement powers, including the following:

Although work on the 1990 Proposals began in 1988, amendments to the legislation arising out of the 1990 Proposals were not incorporated into the Act until 1994. Since that time there has been a significant increase in retail investors' participation in the marketplace. The need for securities regulators to have meaningful and effective enforcement powers has never been greater.

18.3 What Powers Do the Commission and the Court Currently Have?

The Commission's general enforcement powers are set out in Part XXII (Enforcement). The Commission may prosecute an offence by commencing quasi-criminal proceedings in the Ontario Court of Justice under section 122. In these circumstances the Commission may seek a penalty consisting of a fine or imprisonment or both. The Commission may also apply to the Superior Court of Justice for an order that may include one or more of the civil enforcement orders listed in subsection 128(3) or for the appointment of a receiver, trustee or liquidator under section 129. In addition, the Commission may commence administrative proceedings before the Commission under section 127, seeking one or more of the orders provided for under subsection 127(1), which may be made in the public interest.

The provisions in Part XXII deal with:

(a) Prosecution of Offences

Section 122 sets out what constitutes an offence under the Act and the penalties for the commission of an offence.

(b) Exercise of Public Interest Jurisdiction

Section 127 lists the orders that may be made by the Commission, in the public interest. These are:

- an order that a person or company's registration or recognition under Ontario securities law be suspended, restricted, terminated or be subject to terms and conditions;
- an order that trading in securities by or of a person or company cease;
- an order that any exemptions in Ontario securities law do not apply to a person or company;
- an order that a person resign as a director or officer of an issuer or be prohibited from becoming or acting as a director or officer of an issuer;
- an order that a market participant submit to a review of his, her or its practices and institute

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a) Provision for the court to order a person or company found guilty of an offence under the Act to make compensation or restitution to any other person or company.

b) Power of the Commission to order a person or company who has not complied with Ontario securities law to submit to a review of practices and procedures and institute changes.

c) Power of the Commission to order a person or company who has not complied with Ontario securities law to make restitution to any person or company affected by the non-compliance.

d) Power to make certain orders in respect of non-compliance with exchange or self-regulatory organization rules or by-laws, etc. (including compliance order and restitution order).

e) Power to make certain orders in the public interest, including the suspension, restriction or termination of registration or recognition, an order that exemptions do not apply and a cease trade order.

f) Power to make certain orders in respect of a professional person or company that has counselled a breach of securities law, assisted in conduct which constitutes a breach or provided an opinion, advice or information to the Commission or staff which is deceptive or misleading.

[279] *Ibid.* at pp. 405 and 407.

such changes as may be ordered by the Commission;

- if there has been non-compliance with Ontario securities law, an order that a release, report, preliminary prospectus, prospectus, return, financial statement, information circular, take-over bid circular, issuer bid circular, offering memorandum, proxy solicitation or any other document be provided or not be provided to a person or company or be amended; and
- an order that a person or company be reprimanded.

(c) Interim Preservation of Property

Under section 126, the Commission has the authority to make an order for the interim preservation of property (a "freeze" order).

(d) Payment of Costs

Under section 127.1, the Commission may order the payment by a person or company of the costs of an investigation, or those related to a hearing.

(e) Application to Court

Under section 128, the Commission may apply to the court for a declaration that a person or company has not complied with Ontario securities law. If the court makes such a declaration, it may also make any order it considers appropriate. Subsection 128(3) contains a non-exhaustive list of orders that a court may make.[280]

(f) Appointment of Receiver

Under section 129, the Commission may also apply to the court for the appointment of a receiver, receiver and manager, trustee or liquidator of all or any part of the property of any person or company.

18.4 Constitutional and Policy Considerations with Respect to Powers of the Commission

The Committee has considered which of the court powers under subsection 128(3) of the Act, if any, may properly be conferred upon the Commission. In this regard, we have considered whether there may be any constitutional constraints on the extent to which the Commission's powers might be expanded.[281]

Under the *Constitution Act*, the provinces have the power to create courts and the federal government has the power to appoint judges to these courts.[282] This division of power has traditionally been interpreted to prevent provincial governments from conferring on provincial tribunals powers normally exercised by superior, district and county courts, on the basis that any function that had been vested in such courts at the time of Confederation must remain forever in those courts.[283] This view with respect to powers of provincial tribunals has been liberalized over the years. In particular, courts have recognized the different functions of such tribunals in the context of their respective legislative schemes and developed a broader approach to the analysis of the validity of their powers. The Supreme Court of Canada has articulated a three-step test to determine whether a power conferred on a provincial tribunal violates the division of powers under the Constitution Act:[284]

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[280] Included among the listed orders are: an order to comply with Ontario securities law; an order prohibiting a person from acting as an officer or director or prohibiting a person or company from acting as a promoter of any market participant; an order requiring a person or company to compensate or pay restitution to an aggrieved person or company; and an order requiring rectification of any past non-compliance with Ontario securities law.

[281] The Commission, under s. 127, currently has the power to make several orders that are the same as or similar to orders which the court may make under subsection 128(3). These are: an order to submit to a Commission review of practices and procedures, an order directing that a particular document be or not be provided to a person or company, or be amended, and an order prohibiting a person from acting as an officer or director of an issuer.

[282] *Constitution Act* (Canada), subsection 92(14) and s. 96.

[283] For example, see the judgment of Lord Atkin in *Toronto Corporation* v. *York Corporation*, [1938] A.C. 414.

1. Does the challenged power broadly conform to the power or jurisdiction exercised by superior, district or county courts at the time of Confederation?
   - If no, then the power may be validly conferred on a tribunal.
   - If it does, then consider question number two.
2. Is the function of the tribunal a judicial function (i.e., is the tribunal concerned with a private dispute that it is asked to adjudicate through the application of a recognized body of rules, in a fair and impartial manner)?
   - If much of the tribunal's activity does not involve settling private disputes between opposing parties, then the answer to this question may be "no." However, if the tribunal is primarily deciding questions of law or adjudicating private disputes, it may be regarded as exercising judicial powers.
   - If the tribunal does exercise such powers, then consider the third question.
3. If the power of the tribunal is exercised in a judicial manner, does its function as a whole, in its entire institutional context, violate section 96?
   - Consider all of the powers of the tribunal. If the judicial power is incidental to the tribunal's administrative powers, then section 96 is not violated. If the judicial or adjudicative function is the sole or central function of the tribunal, the power is invalid.

The Commission's mandate is to regulate the securities industry in a manner that provides effective protection to investors while fostering fair and efficient capital markets and confidence in those markets. The Supreme Court of Canada has recognized the importance of this mandate, as well as the broad discretion of a securities regulator to determine what is in the public interest.[285] It therefore appears likely that the courts would view the exercise by the Commission of one or more of the powers of the court under subsection 128(3) as being incidental to the Commission's administrative powers. However, this issue should be kept in mind as proposed new powers are considered.

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[284] *Reference re Residential Tenancies Act* (N.S.) (1996), 131 D.L.R. (4th) 609; *Massey-Fergusson Industries Ltd.* v. *Sask.* [1981], 127 D.L.R. (3d) 513.

[285] *Pezim* v. *British Columbia (Superintendent of Brokers)* [1994], 114 D.L.R. (4th) 385; *British Columbia (Securities Commission) v. Branch* [1995], 123 D.L.R. (4th) 462.

Chapter 19: What New Powers Should the Commission Have?

With the enforcement powers presently available to it under subsection 127(1) of the Act, the Commission is constrained in its ability to fashion an appropriate remedy in all situations. For example, there may be situations in which the removal of exemptions or a reprimand may not send a sufficiently strong deterrent message. In other cases, the imposition of a cease trade order may not be appropriate, as it may harm innocent shareholders of the issuer. There may be some circumstances where the imposition of an administrative fine would be the most appropriate sanction; however, this is not currently available to the Commission. Of overriding importance is the need for flexibility, so that the remedy ordered can be fashioned to appropriately address the impugned conduct.

19.1 Administrative Fine

(a) Other Jurisdictions

The Commission does not have the power to order payment of an administrative fine, although many administrative bodies do have this power, including securities regulators in British Columbia, Alberta, Saskatchewan, Manitoba, Quebec and Nova Scotia as well as in the United States and the United Kingdom. The British Columbia, Alberta, Saskatchewan, Manitoba and Nova Scotia Acts empower their respective commissions to order payment of an administrative fine where they determine that there has been a contravention of their Act, the regulations or a decision (in Saskatchewan and Manitoba, also a written undertaking to the Commission or the Director under that Act), and it is in the public interest. Under the Quebec Act, the Commission may impose an administrative fine when it becomes aware of facts establishing a failure to discharge an obligation under that Act or the regulations. Similarly, the provisions in the applicable U.S. and U.K. legislation tie the imposition of an administrative fine to a finding that there has been a contravention. In addition, the TSX and the IDA have the power to impose fines where there has been a violation of the applicable requirements.[286] In our view, the Commission should also have this power.

(b) Range of Penalties

In order for the Commission to be able to tailor sanctions to suit the particular circumstances, it is important for there to be a range of administrative fines available. In our view, the maximum amount for an administrative fine must be sufficient to allow the Commission to send an appropriate deterrent message, having regard to both the gravity of the conduct under consideration and the respondents that are the subject of the proceedings. The more egregious the conduct being sanctioned, the more important it is for the Commission to be able to send a strong signal to the marketplace. The administrative fine that the Commission is able to impose should not be viewed merely as a "cost of doing business" or a licensing fee.

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[286] The Alberta Securities Commission has the power to impose a maximum administrative fine of $100,000 for an individual and $500,000 for any other person or company, for each contravention of or failure to comply with the Alberta Act. The Manitoba Securities Commission has the power to impose a maximum administrative fine of $100,000 for an individual and $500,000 for any other person or company. The British Columbia, Saskatchewan and Nova Scotia Securities Commissions each can order a maximum administrative fine of $100,000. The Saskatchewan Securities Commission may also order that a person or company pay the cost of producing material specified by the Commission to promote knowledge of investment and regulatory matters, up to a maximum of $100,000. The Quebec Securities Commission may impose an administrative fine of up to $1,000,000. The SEC can impose administrative fines that range from U.S. $5,000 to $100,000 for a natural person and from U.S. $50,000 to $500,000 for any other person, for each violation. The FSA has recently been afforded the power to impose a fine, with no stated maximum, pursuant to the new *Financial Services and Markets Act 2000* (U.K.), 2000, Chapter c.8. Both the IDA and the TSX have the power to impose fines in an amount not exceeding the greater of $1,000,000 (per offence, in the case of the IDA) and an amount equal to three times the pecuniary benefit that accrued to the person as a result of committing a violation.

Different approaches may be taken in respect of the amount and application of administrative fine provisions. For example, fines may apply on a "per contravention" or "per violation" basis and may be tiered in different ways. Individuals may be subject to lower fines than corporate entities and fines may increase depending on the wilfulness of the conduct and the level of harm. Of the different fine amounts we have considered, the highest amount that may be imposed by a securities commission in Canada is in the Quebec Act. The Quebec Securities Commission recently obtained the power to impose an administrative fine of up to $1,000,000.

(c) Appropriate Maximum Fine

We are of the view that the Commission should have the power to impose an administrative fine up to a maximum of $1,000,000. We do not recommend that the proposed fine be tiered. Setting a maximum amount in this way gives the Commission the flexibility to take into account the particular circumstances of each case, including the nature of the respondent. We are also of the view that an administrative fine provision in the Act should be modelled on the provision in the Alberta Act, which provides that the fine may be imposed for each contravention or failure to comply with that Act, the regulations or a decision.[287] This makes it clear that a fine may be imposed in respect of each instance of a contravention, as opposed to being imposed on a general basis.

Given the size of the capital market in Ontario and the need for the Commission to have meaningful enforcement powers, an administrative fine in an amount that could be up to $1,000,000 per contravention is reasonable and will enable the Commission to send an appropriate deterrent message. If the Commission is given the power to order payment of an administrative fine, we would strongly urge the Commission, in any reasons it gives when imposing such a fine, to give explicit guidance as to the matters it considered in assessing whether the fine should be imposed and the quantum of the fine.

(d) Circumstances in Which Administrative Fines Should Be Applied

As is the case for securities regulators in the other Canadian jurisdictions referred to above, the Commission's ability to impose an administrative fine should be exercisable where there has been a contravention of Ontario securities law and it is in the public interest to impose such a fine. We are aware that there are other remedies available to the Commission which do not require there to have been a contravention of securities legislation but rather, simply a finding that the conduct is contrary to the public interest (for example, the revocation of registration). However, we recognize that the imposition of an administrative fine may be viewed as a different kind of remedy from the others currently listed in section 127 of the Act and that principles of natural justice are better served by tying the imposition of an administrative fine to a demonstrated breach of Ontario securities law.

(e) Constitutional Issues

While a number of administrative bodies, including securities regulators, have the power to impose an administrative fine, there may be some risk that an administrative fine of the magnitude recommended by this Committee may be challenged as being penal in nature, thereby having the effect of transforming the administrative nature of Commission proceedings, and possibly triggering constitutional, or even Charter concerns.[288] We are not aware of any decisions in which an administrative fine provided for in securities laws of other jurisdictions in Canada has been found to invoke the Charter rights.

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[287] Alberta Act, subsection 199(1).

In fact, in two cases in British Columbia, the administrative fine power has withstood challenge.[289] In a British Columbia Supreme Court decision, the court stated that the introduction of administrative fines to the British Columbia Act did not change the whole character of that Act and that it remained a regulatory scheme and was not thereby transformed into a penal statute.[290] In a more recent decision, the British Columbia Court of Appeal also found that the administrative fine provision in the British Columbia Act did not alter the basic character of that Act as regulatory legislation.[291] In its decision, the Court of Appeal referred to the decision of the Supreme Court of Canada in the *Asbestos* case (which addressed the public interest jurisdiction of the Commission under section 127 of the Act). In considering the *Asbestos* decision, the British Columbia Court of Appeal noted that, while there is no administrative fine provision in the Act (in Ontario), such a fine fits within the class of sanctions discussed by Mr. Justice Iacobucci in *Asbestos*, where he stated:

> The enforcement techniques in the Act span a broad spectrum from purely regulatory or administrative sanctions to serious criminal penalties. The administrative sanctions are the most frequently used sanction and are grouped together in subsection 127 as "Orders in the public interest". Such orders are not punitive: *Re Albino* (1991), 14 O.S.C.B. 365. Rather, the purpose of an order under subsection 127 is to restrain future conduct that is likely to be prejudicial to the public interest in fair and efficient capital markets. The role of the OSC under subsection 127 is to protect the public interest by removing from the capital markets those whose past conduct is so abusive as to warrant apprehension of future conduct detrimental to the integrity of the capital markets: *Re Mithras Management Ltd.* (1990), 13 O.S.C.B. 1600. In contradistinction, it is for the courts to punish or remedy past conduct under ss.122 and 128 of the Act respectively: see D. Johnston and K. Doyle Rockwell, Canadian Securities Regulation (2nd ed. 1998), at pp. 209-11."[292]

We find support in the comments of the British Columbia Court of Appeal for our view that the power in securities legislation to impose an administrative fine is an appropriate administrative sanction.

19.2 Disgorgement of Profits

There may be cases in which the conduct in question has resulted in a financial gain to the person or company who has contravened Ontario securities law. In such cases, while other sanctions may also be appropriate, it seems inappropriate that such person or company should be able to retain any "illegal" profit. An order for the disgorgement of such profit would serve to maximize the deterrent effect of the overall sanction. The SEC has the power to order disgorgement and an accounting, both in the context of a cease and desist proceeding and in the context of an order for the payment of an administrative fine, and has adopted special rules to deal with this.[293] As the primary purpose of such an order is to deprive a wrongdoer of ill-gotten gains, the amount of disgorgement that may be ordered is limited to the amount of the illegal profits.[294] In our view, the Commission should also have the flexibility to make such an order.

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[288] This issue was considered by the Supreme Court of Canada, albeit in a different context, in *R.* v. *Wigglesworth*, [1987] 2 S.C.R. 541. In that case an RCMP officer was convicted of assaulting a prisoner under the *Royal Canadian Mounted Police Act* and fined $300 by an RCMP service tribunal. He was subsequently charged with criminal assault for the same incident. The Supreme Court of Canada found that s. 11(h) Charter rights were not infringed by the dual proceedings. Section 11(h) of the Charter describes the right, if found guilty of an offence and punished, not to be tried or punished for it again. In its consideration of the issue, the Court indicated that the possibility of an administrative fine taking on a penal consequence, increases with its magnitude: "In my opinion, a true penal consequence which would attract the application of section 11 is imprisonment or a fine which by its magnitude would appear to be imposed for the purpose of redressing the wrong done to society at large rather than to the maintenance of internal discipline within the limited sphere of activity" (per Wilson, J.).

[289] The British Columbia Securities Commission was the first securities commission in Canada to have the authority to impose an administrative fine.

[290] *British Columbia (Securities Commission)* v. *Simonyi-Gindele*, [1992] B.C.J. No. 2893 Vancouver A 921540. (This case did not involve a Charter challenge.)

[291] *Johnson* v. *British Columbia (Securities Commission)*, [2001] B.C.J. No. 2103 (B.C.C.A.).

[292] *Asbestos, supra* note 274, at para. 43, quoted in *Johnson, ibid.*

We recommend that the Commission have the power to order the disgorgement of profits made by a respondent as a result of a contravention of Ontario securities law. Like the imposition of an administrative fine, a disgorgement order can send a strong deterrent message in situations in which the respondent has profited from its improper actions.

We acknowledge that there may be procedural concerns in connection with the power to order disgorgement of profits, including matters relating to the determination of entitlement to disgorged monies and the extent of such entitlement. However, we do not think that is a reason not to recommend the authority. The Commission is in the best position to determine whether or not a particular situation is one in which a disgorgement order is appropriate, based on all the circumstances.

19.3 Application of Money Paid as Administrative Fine or Disgorged Profits

We considered how money paid to the Commission as an administrative fine or pursuant to a disgorgement order should be applied. In examining this issue, we reviewed how the Act currently deals with monies paid pursuant to a settlement agreement. We view monies paid under a negotiated settlement agreement, as an administrative fine, or paid pursuant to a disgorgement order as all being analogous. We also examined on a comparative basis how other provinces treat administrative fines.

The Commission has the authority under the Act to retain for its own use the fees it charges and revenue generated from the exercise of a power or duty.[295] The Minister of Finance can require the Commission to pay surplus funds that it accumulates into the Consolidated Revenue Fund, if doing so will not impair the capacity of the Commission to meet its financial and contractual commitments. Money received by the Commission as a payment to settle enforcement proceedings must be paid into the Consolidated Revenue Fund unless it is (a) to reimburse the Commission for costs incurred or to be incurred or (b) "designated under the terms of the settlement for allocation to or for the benefit of third parties." [296] Designated settlement payments received by the Commission are paid into a separate account and held in trust for the benefit of third parties.

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[293] 1933 Act, clause 8A(e); 1934 Act, clauses 21C(e) and 21B(e); and SEC Rules of Practice – Rules Regarding Disgorgement and Penalty Payments, Rules 600, 601, 611-614, 620 and 630.

[294] The funds recovered by the SEC in such circumstances are typically paid into an escrow account established for the benefit of those injured by the illegal activity. The funds are administered and distributed in accordance with a plan that is submitted by the SEC's Division of Enforcement (unless otherwise ordered). The plan must include procedures for selecting a fund administrator to oversee the fund and process claims, as well as procedures for making and approving claims. The plan must be published for comment and is subject to approval by the SEC or a hearing officer. The fees and expenses of administering the plan are generally paid first from the interest earned on the disgorged funds, and then from the funds themselves. Any undistributed funds may become the property of the United States Treasury.

[295] The Act, subsection 3.4(1). The money received must be applied to carrying out the duties and powers of the Commission.

[296] The Act, subsection 3.4(2). These provisions were added to the Act in 1997, when the Commission became self-funding. The purpose of the exception in subsection 3.4(2) is to ensure against the potential for a conflict of interest. Without this provision, it could be argued that the Commission would be in the position to encourage settlements, not because they are in the public interest, but rather to generate additional revenue.

The provinces take different approaches with respect to the application of administrative fines imposed by securities commissions. Alberta requires that the money received from administrative fines be used for "endeavours or activities that … enhance or may enhance the capital market in Alberta."[297] British Columbia, Quebec and Saskatchewan generally direct that money received from administrative fines be used for the purpose of promoting knowledge of capital market participants (or, specifically, investor education).[298]

We endorse the approach in the Act for dealing with money received from a negotiated settlement and believe that the same approach should be taken with respect to money received pursuant to an administrative fine or a disgorgement order. It seems sensible to us that where harm has been done to the capital markets or investors have suffered losses the Commission should have the flexibility to designate that monies paid by a respondent in the context of an enforcement proceeding be allocated for the benefit of third parties. This approach is also consistent with the legislative scheme of several of the other provinces. We are concerned, however, that the current provision in the Act is not specific enough and should be amended, by adding the words "in furtherance of the purposes of the Act"[299] in connection with funds that are designated or ordered to be used for the benefit of third parties, whether pursuant to a settlement agreement, administrative fine or disgorgement order. This provides further clarification as to how such monies should be applied.

We understand that settlement payments received by the Commission that are allocated to or for the benefit of third parties have historically been used for investor education purposes. While this is an appropriate use for such funds, there are other possible uses, including assisting investors who have been harmed by the contraventions that resulted in a payment to the Commission. We encourage the Commission to consider various ways in which third parties may be benefited, in light of the particular circumstances which gave rise to the settlement payment, administrative fine or disgorged profits. If the Commission determines that it would be appropriate to direct that money allocated to or for the benefit of third parties be used to compensate them for losses incurred by them, the Commission should adopt the SEC model of using a trustee to administer the disgorged funds.

We recommend that money received by the Commission as an administrative fine or pursuant to a disgorgement order should be paid into the Consolidated Revenue Fund, unless it is designated under the terms of the order imposing the fine or directing disgorgement for allocation to or for the benefit of third parties in furtherance of the purposes of the Act.

Recommendations:

1. **We recommend that section 127 of the Act be amended to add new paragraphs authorizing the Commission, if in its opinion it is in the public interest, and if it determines that a person or company has contravened Ontario securities law, to make an order:**

   - **requiring the person or company to pay an administrative fine of up to $1,000,000 per contravention of Ontario securities law.**

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[297] Under subsection 19(5) of the Alberta Act, administrative fines are not to be used for normal operating expenditures of the Commission and must only be used "for endeavours or activities that in the opinion of the Commission enhance or may enhance the capital market in Alberta".

[298] Under subsection 15(3) of the British Columbia Act, money received from administrative fines may be used only "for the purpose of promoting knowledge of participants in the securities markets of the legal, regulatory and ethical standards that govern the operation of the securities market in British Columbia." Under s. 273.1 of the Quebec Act, administrative fines are to be paid into a designated fund and "allocated to the education of investors or the promotion of their general interest." Under clause 135.1(2)(b) of the Saskatchewan Act, the Commission has the power to order that a person or company pay the cost of producing material specified by the Commission "to promote knowledge of participants in the capital markets of investment and regulatory matters."

[299] These purposes are, generally, investor protection and fostering fair and efficient capital markets and confidence in their integrity.

- **requiring a person or company to disgorge profits made as a result of its contravention of Ontario securities law.**

2. **In addition, we recommend that subsection 3.4(2) of the Act be amended to read as follows:**

   The Commission shall pay into the Consolidated Revenue Fund money received by it as a payment to settle enforcement proceedings commenced by the Commission, *or pursuant to an order made by the Commission pursuant to section 127,* but not money received by the Commission,

   - **to reimburse it for costs incurred or to be incurred by it; or**
   - **that is designated under the terms of the settlement *or identified in a Commission decision* as money to be used for allocation to or for the benefit of third parties *in furtherance of the purposes of the Act.*[300]**

19.4 Breach of Undertaking

In many situations, persons or companies dealing with the Commission "undertake" to the Commission to take certain action. Undertakings may be given in the ordinary course of dealings with the Commission and may be given to the Executive Director, a director or staff, depending on the circumstances. In a prospectus context, for example, undertakings may be given in connection with the filing of documents. In the enforcement context, an undertaking may be used as a term of settlement with respect to a matter that is the subject of an investigation or examination or an enforcement proceeding.

The Commission currently has no authority to enforce undertakings. The absence of clear authority in this regard might have an effect on the way in which certain persons view compliance with their undertakings.

The Committee is of the view that undertakings play a meaningful role in the enforcement process by giving the Commission the flexibility to accommodate particular circumstances and to achieve an outcome which may not otherwise be available through administrative proceedings. We also believe it is important that this flexibility be preserved, to the extent possible, in a manner that recognizes the gravity of the circumstances and ensures that an undertaking will be taken seriously. One way of accomplishing this is to make it an offence, under the Act, to breach an undertaking.

The Committee considered provisions under other securities legislation in Canada, which provide that it is an offence to breach an undertaking.[301] Under the Quebec Act the offence relates to undertakings given to the Quebec Securities Commission, while under the Alberta Act, it relates to written undertakings given to the Commission or the Executive Director, and under the Saskatchewan Act, it relates to written undertakings given to the Commission or the Director. There is no similar provision in the Act. The Committee recommends that the Act be amended to provide that the breach of a written undertaking to the Commission or the Executive Director is an offence. As a result, if such a breach were to occur, the Commission would then be in a position to make an order under section 127, prosecute in respect of the offence under section 122, or seek an order of the court under section 128 of the Act. The avenue chosen, if any, would depend on the nature and severity of the breach. We believe that if there were a potential for such consequences in the event of a breach of an undertaking, this would cause market participants to take undertakings seriously.

Recommendation:

We recommend that a new offence be created under section 122 of the Act, for failing to fulfil, or contravening a written undertaking to the

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[300] Amendments to subsection 3.4(2) are shown in italics.

[301] Alberta Act, clause 194(1)(e); Quebec Act, subsection 195(2); and Saskatchewan Act, clause 131(3)(e).

Commission or the Executive Director.

19.5 Restitution or Compensation Order

The Committee considered whether the Commission should have the power to order that a registrant repay to its clients all or any of the money paid by clients for securities purchased through the registrant where the registrant has engaged in misconduct vis-à-vis such clients.

(a) Commission's Authority

The Commission has no authority under the Act to make a restitution or compensation order. This is consistent with the objective of regulatory legislation in general and the Commission's public interest jurisdiction, which is protective, not remedial.[302] This is also consistent with the powers of securities commissions and regulatory authorities in other provinces and territories in Canada and in the United States and Australia, none of whom currently has the direct power to order restitution or compensation.

We note, however, that the new *Financial Services and Markets Act 2000* in the United Kingdom gives the FSA the direct power to order restitution, in addition to the power to obtain a restitution order from the court.[303] This suggests a change in the traditional notions that regulatory powers are not remedial. This is an evolving area and while we are of the view that it may not be necessary or appropriate for the Commission to have the power to order restitution at this time, particularly if our recommendations relating to disgorgement of profits are adopted, we realize that this may change. Given that the FSA has just obtained the power to order restitution, we recommend that the Commission monitor the FSA's exercise of its new power and consider the experience in the United Kingdom, including the practical implications of the exercise of this power, before making a determination as to whether the Commission should be able to order restitution.

Recommendation:

We recommend that the Commission monitor the FSA's exercise of its new restitution power and consider the experience in the United Kingdom, with a view to revisiting in the future whether a power to order restitution would be an appropriate remedy for the Commission.

(b) Authority of the Court under Section 128

The Commission has the discretion under section 128 of the Act to apply to the court for a declaration that a person has not complied with or is not complying with Ontario securities law. In making such an order the court may also order a wide range of remedies, including an order for compensation or restitution. We understand that the Commission has only once applied to the court for a restitution or compensation order.[304] We encourage the Commission to consider exercising its discretion under that section to seek an order of the court for restitution or compensation in appropriate cases.

Recommendation:

We encourage the Commission to consider exercising its discretion, in appropriate cases, to apply to the court under section 128 of the Act for a restitution or compensation order.

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[302] *Asbestos, supra* note 274. As Iacobucci, J. stated, "[t]he focus of regulatory law is on the protection of societal interests, not punishment of an individual's moral faults" (at para. 42). See also the comments of Laskin, J.A., in the decision of the Ontario Court of Appeal, in *Asbestos,* that "[t]he purpose of the Commission's public interest jurisdiction is neither remedial nor punitive; it is protective and preventative, intended to be exercised to prevent likely future harm to Ontario's capital markets" ((1999), 43 O.R. (3d) 257, at p. 272).

[303] *Financial Services and Markets Act 2000, supra* note 286, s. 384.

[304] *Ontario (Securities Commission)* v. *Sides* (1996), 19 OSCB 2056 (Ontario Court of Justice (General Division)).

19.6 Complaint-Handling and Dispute Resolution

In our Issues List, we asked whether financial services regulators, including SROs, should have the ability to handle consumer complaints through ombudsman or arbitration programs.

Investors may take steps themselves to attempt to recover money they have lost as a result of the misconduct of a registrant. While investors can always bring civil action in the courts, there are strong disincentives to doing so because of the time and cost involved in bringing a civil action. As a result, alternatives have been developed to make it easier for investors to resolve disputes with service providers in the industry. Two examples of such alternatives are:

- the Canadian Banking Ombudsman; and
- the IDA arbitration program.

These alternatives are discussed below.

(a) Canadian Banking Ombudsman

Under the *Bank Act*, all banks are required to have internal complaint-handling procedures and must file a copy of these procedures with the Financial Consumer Agency of Canada.[305] Banks make their customers aware of their complaint-handling procedures in a number of ways, including staff referrals, brochures, websites and ombudsman annual reports. In addition, a number of the banks have joined in setting up the office of the Canadian Banking Ombudsman (the "CBO"). The Committee heard from Michael Lauber, the current CBO, who explained to us that the CBO provides customers of banks and related financial service providers that are members of the CBO with another level of complaint-handling and dispute resolution in the event that they have been unable to resolve their issues satisfactorily at the level of the individual bank or service provider. The services of the CBO are available free of charge to any individual or small business customer who has a complaint about a participating member and any of its subsidiaries, which has not been resolved directly with the member in a manner acceptable to the customer.[306] If the CBO makes a recommendation with respect to a complaint, the recommendation is not binding on either the member or the customer. However, the CBO is required to publish the name of any member that does not comply with the recommendation. Mr. Lauber advised us that, in his experience, all of the CBO's recommendations have been implemented.

In a recent set of amendments to its financial institutions legislation, the Government of Canada provided for the creation of a Canadian Financial Services Ombudsman ("CFSO"), the structure of which appears to be loosely based on that of the CBO,[307] and in which membership would be mandatory for federally regulated financial institutions. The Government of Canada announced on December 20, 2001, that it has suspended its plan to implement the CFSO, in light of the announcement by various representatives of the financial services industry sector regarding the planned creation of a National Financial Services OmbudService. (See discussion at section 19.6(c) below.)

(b) IDA Arbitration Program

The IDA has set up an arbitration program that is designed to assist clients in the recovery of money from dealers. The arbitration program is available, at the client's option, with respect to claims up to $100,000. Unless the parties otherwise agree, the proceedings are confidential and hearings are in private. The costs of the arbitration are generally shared equally by the parties and each party must bear its own legal and other costs. The advantages of this program are that it is less costly and formal than litigation in the courts and it gives an investor the opportunity to recover money in a relatively quick fashion. The disadvantages are that it does involve a cost to the investor and may involve an imbalance of power, since the member firm is likely to have more resources than the investor and be in a better position to oppose the claim. In addition, we understand that there is no statistical reporting by the IDA as to the types or number of cases that go to arbitration, or of the results of arbitration.

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[305] *Bank Act*, s. 455.

[306] The CBO publicizes its ombudsman service through printed information, a website and quarterly and annual reports.

[307] Bill C-38, *An Act to establish the Financial Consumer Agency of Canada and to amend certain Acts in relation to financial institutions*, came into force on October 24, 2001. See s. 121 of Bill C-38.

While we support the concept of alternative dispute resolution for the securities industry, we are concerned about the lack of transparency in the IDA arbitration program and strongly encourage the IDA and any other SROs that have or may be contemplating similar programs to, at a minimum:

- require that their members advise customers of the availability of the arbitration or similar program at the commencement of their relationship and at any subsequent point at which a complaint or dispute arises; and
- publish, or otherwise make generally available, statistics relating to the use of such programs, including information as to the member involved in the arbitration, a description of the case, the outcome of the case and the amount of any monetary award made.[308]

(c) The Joint Forum Task Force on Dispute Resolution – National Financial Services OmbudService

In response to the Government of Canada's proposed creation of a CFSO, the Joint Forum created a Task Force on Dispute Resolution, the purpose of which was to work toward the development of a comprehensive dispute resolution system that would cover the entire financial services sector in Canada and that would work in co-operation with, or instead of, the CFSO.[309] In a news release issued December 20, 2001, representatives of five major constituent industries of Canada's financial services sector[310] announced the creation of a National Financial Services OmbudService (now called the Financial Services OmbudSystem (FSOS)). The announcement indicates that the FSOS, which is planned to be in place by July 1, 2002, will provide more than 95 per cent of Canada's financial services consumers with single-window access to recourse if they have concerns or complaints. The FSOS will build on consumer redress mechanisms that are already in place and will include a new organization, the Financial Services OmbudCentre, which will provide a central contact point, establish and maintain standards, undertake awareness-raising and provide reports on the system.[311] The FSOS has been endorsed by the Joint Forum, the Canadian Council of Insurance Regulators, the Canadian Association of Pension Supervisory Authorities and the CSA.

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[308] We understand that this is the kind of information that is maintained in a central registration depository in the United States, which keeps data on the firms and brokers registered with the NASD. This information is made available through NASD Regulation's "Public Disclosure Program."

[309] The Joint Forum Task Force on Dispute Resolution consists of representatives of the CSA, the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities as well as representatives of the various affected industry groups (securities, pensions, life insurance, property and casualty insurance, banking, other deposit-taking), consumers and the Government of Canada.

[310] These representatives are: the Canadian Bankers Association, the Canadian Life and Health Insurance Association Inc., the Insurance Bureau of Canada, the IDA, the Investment Funds Institute of Canada and the MFDA.

[311] According to the press release, the core components of the FSOS are: the individual companies in the participating industries and their ongoing complaints management activities; industry-level consumer recourse mechanisms which will include independent, impartial ombudsman services for consumers whose complaints have been dealt with at the company level and wish to pursue their complaints further; and the new Financial Services OmbudCentre.

(d) Recommended Features of a Complaint-Handling/Dispute Resolution System

The submissions to the Committee on this matter indicated general support for a complaint-handling or dispute resolution system for the financial services industry. This is consistent with the work being done in this area. We recognize the importance of a complaint-handling system for the financial services industry as a whole and look forward to the establishment of the FSOS. We encourage the establishment of a complaint-handling system which should have, among others, the following characteristics:

- A system that is national in scope, deals with complaints from consumers across Canada with respect to their dealings with providers of financial services and products and is funded jointly by industry and regulators.
- A system that is independent of both government and the industry, to ensure the perception of independence, as well as independence in fact.
- "A single window" format, with initial contact made to a centralized call centre that would be responsible for providing information and general guidance on the complaint-handling process, allocating or referring complaints, compiling statistics in respect of complaints, preparing public reports, and ensuring the transparency of the system.
- A system that recognizes that the first step in a complaint-handling process is to address the matter at the level of the financial services provider (i.e., through the internal complaint-handling process set up by the financial services provider).
- A system that includes an Ombudsman who has the authority to facilitate the resolution of complaints between the parties without the need for further intervention. Where such a resolution is not possible, the Ombudsman would have the authority to make a decision. If the consumer accepts the decision, it would then be binding on the provider. If the consumer does not accept the decision, this would not affect his or her ability to pursue the complaint through other avenues, such as arbitration or litigation. Further, the consumer would not be required to pursue the Ombudsman route prior to or in lieu of arbitration or litigation.
- A system in which industry participation is mandatory. In this regard we recommend that the Commission require, as a condition of its recognition of any SRO, that the SRO require its members to participate in and agree to be bound by any national complaint-handling system as well as by any industry-sponsored dispute resolution program, such as the arbitration program set up by the IDA, where applicable.

The next step in this area will be to create a similar national system for dispute resolution. We encourage the financial services industry to work toward the goal of having a national system with a seamless process for both handling complaints and resolving disputes of consumers of financial services across Canada.

Recommendations:

1. **We encourage the establishment of a national complaint-handling system in which participation by financial services providers is mandatory. The system should be independent of government and industry, provide information and general guidance on the complaint-handling process, and have a centralized system for handling calls and compiling and reporting statistics. The system should also include an Ombudsman who would have the authority to make decisions that are binding on the financial services provider but not the investor. The investor's right to further pursue the complaint through**

other available avenues, such as arbitration or litigation, would be unaffected.

2. **We also recommend that, as a condition of its recognition of an SRO, the Commission should require the SRO to require its members to participate in and agree to be bound by any national complaint-handling system that is in place, as well as any industry-sponsored dispute resolution program that may be applicable. We favour transparency in connection with such programs and strongly encourage the publication of statistics relating to the use of the programs as well as particulars concerning the outcomes of cases or the resolution of complaints.**

3. **We strongly encourage the IDA and any other SROs that have or may be contemplating alternative dispute resolution programs to, at a minimum, require their members to advise customers of the availability of such programs and publish the statistics relating to the program.**

4. **We encourage further work by the financial services industry toward the goal of creating a national dispute resolution system and ultimately consolidating the complaint-handling and dispute resolution systems into one seamless process.**

Chapter 20: Which Existing Powers of the Commission Should Be Broader?

20.1 Order Resignation as Director or Officer; Prohibit from Becoming or Acting as Director, Officer, Mutual Fund Manager or Promoter

The Commission currently has the power, under paragraph 127(1)7, to order that a person resign one or more positions that he or she holds as director or officer of an issuer. Under paragraph 127(1)8, the Commission has the power to prohibit a person from becoming or acting as a director or officer of an issuer. The Committee considered:

- whether these powers should remain limited in their application to directors or officers of issuers, or whether they should be expanded to include directors or officers of other market participants, such as registrants and mutual fund managers; and
- whether the power to prohibit a person from becoming or acting as an officer or director should be expanded to include the power to prohibit a person or company from becoming or acting as a promoter or engaging in promotional activities in connection with the purchase or sale of securities of an issuer, and the power to prohibit a person or company from acting as a mutual fund manager.

The Committee recommends that the power to order a person to resign or prohibit a person from becoming or acting as, an officer or director of an issuer should be expanded to permit the Commission to order a person to resign or prohibit a person from becoming or acting as, an officer or director of a registrant or as an officer or director of a manager of a mutual fund. Managers of mutual funds are not currently required to be registered and the Commission has no authority to prohibit a person or company from becoming or acting as a mutual fund manager. We believe that the Commission should have this authority.

The Committee also considered whether the Commission should have the power to make an order prohibiting a person from becoming or acting as a promoter. While this is included as a power of the court, under paragraph 128(3)7 of the Act,[312] we are of the view that the Commission should also have this power, just as it has the power to prohibit a person from becoming or acting as a director or officer of an issuer.

In considering this issue we focussed on the narrow definition of "promoter" in the Act,[313] which is directed mainly at the acts of founding, organizing or substantially reorganizing the business of an issuer. This definition focuses on the promoter's involvement in the formative stage of an issuer's development. Today, however, many issuers engage persons or companies to promote the purchase or sale of the issuer's securities. Where such activity is not related to the founding, organization or substantial reorganization of the business of an issuer, the Commission would have no authority to prohibit someone from carrying out such activity where it is found to be contrary to the public interest. The British Columbia Securities Commission has the power to prohibit a person from engaging in this type of activity, which is captured in the definition of "investor relations activities" in the British Columbia Act.[314] The definition of "investor relations activities" in the British Columbia Act does not include providing information in the ordinary course of business (to promote the products or services of the issuer or to raise public awareness of the issuer), communications necessary for regulatory compliance, or communications in newspapers, magazines or business publications that are in general circulation. Further, it does not purport to deal with interactions with investors or the public that do not promote or could not be reasonably expected to promote the purchase or sale of securities of the issuer.

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[312] Pursuant to paragraph 128(3)7 of the Act, the court has the power to make an order prohibiting a person from acting as an officer or director, or prohibiting a person or company from acting as a promoter, of any market participant permanently or for such a period as is specified in the order. The equivalent power of the Commission under paragraph 127(1)8 is limited to the power to order that a person is prohibited from becoming or acting as a director or officer of any issuer and does not include a power to prohibit a person or company from becoming or acting as a promoter.

[313] "Promoter" is defined in subsection 1(1) of the Act to mean:

(a) a person or company who, acting alone or in conjunction with one or more other persons, companies or a combination thereof, directly or indirectly, takes the initiative in founding, organizing or substantially reorganizing the business of an issuer, or

(b) a person or company who, in connection with the founding, organizing or substantial reorganizing of the business of an issuer, directly or indirectly, receives in consideration of services or property, or both services and property, 10 per cent or more of any

We considered whether the existing definition of promoter under the Act should be expanded to include securities-related promotional activities which are captured in the British Columbia Act under the definition of "investor relations activities." However, we concluded that this would not be appropriate, since there are responsibilities and potential liabilities associated with promoters which should not necessarily attach to persons or companies engaged in investor relations activities.

We believe that the Act should include the concept of promotional activities in connection with the purchase or sale of an issuer's securities similar to the definition of "investor relations activities" in the British Columbia Act and that the Commission should have the power to prohibit a person or company from engaging in such activities. In making this recommendation, we would emphasize that we think "investor relations activities" can be an integral part of the corporate communication strategy. Our recommendation should not be construed as critical of investor relations professionals. We are suggesting, rather, that the Commission ought to have the power to deal with inappropriate "touting" of securities and promotional activities relating to the purchase and sale of an issuer's securities, where conduct contrary to the public interest can be demonstrated.[315]

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class of securities of the issuer or 10 per cent or more of the proceeds from the sale of any class of securities of a particular issue, but a person or company who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this definition if such person or company does not otherwise take part in founding, organizing, or substantially reorganizing the business.

[314] "Investor relations activities" is defined in subsection 1(1) of the British Columbia Act to mean: any activities or oral or written communications, by or on behalf of an issuer or security holder of the issuer, that promote or reasonably could be expected to promote the purchase or sale of securities of the issuer, but does not include:

(a) the dissemination of information provided, or records prepared, in the ordinary course of the business of the issuer

  i) to promote the sale of products or services of the issuer, or

  ii) to raise public awareness of the issuer, that cannot reasonably be considered to promote the purchase or sale of securities of the issuer,

(b) activities or communications necessary to comply with the requirements of

  i) this Act or the regulations, or

  ii) the bylaws, rules or other regulatory instruments of a self regulatory body or exchange,

(c) communications by a publisher of, or writer for, a newspaper, news magazine or business or financial publication, that is of general and regular paid circulation, distributed only to subscribers to it for value or to purchasers of it, if

  i) the communication is only through the newspaper, magazine or publication, and

  ii) the publisher or writer receives no commission or other consideration other than for acting in the capacity of publisher or writer, or

(d) activities or communications that may be prescribed for the purpose of this definition.

[315] The clear parallel to this proposed sanction is the Commission's power under paragraph 127(1)8 of the Act to prohibit a person from becoming or acting as a director or officer of any issuer. This does not assume that directors and officers act improperly in

Recommendations:

1. **We recommend that paragraph 127(1)7 of the Act be amended to authorize the Commission to order that a person resign one or more positions that the person holds as a director or officer of an issuer, *registrant or manager of a mutual fund*.**

2. **We recommend that paragraph 127(1)8 of the Act be amended to authorize the Commission to order that:**
   - **a person be prohibited from becoming or acting as a director or officer of any issuer, *registrant or manager of a mutual fund*;**
   - ***a person or company be prohibited from becoming or acting as a manager of a mutual fund or as a promoter;* and**
   - ***a person or company be prohibited from engaging in touting of securities or promotional activities relating to the purchase or sale of an issuer's securities.*[316]**

3. **We also recommend that the Act be amended to include a definition of touting of securities or promotional activities, similar to the definition of "investor relations activities" in the British Columbia Act.[317]**

20.2 Compliance Order

(a) Power to Enforce Compliance with Ontario Securities Law

While the Commission currently has the power to make a number of orders that may be characterized as requiring compliance with the Act, these orders are directed to specific circumstances rather than applying more generally to situations that involve a contravention of Ontario securities law.[318]

A general power to order compliance with Ontario securities law:

- is consistent with the protective and preventative nature of the Commission's role in the exercise of its enforcement powers because it would give the Commission the authority to direct market participants to comply with or cease contravening Ontario securities law.
- would permit the Commission to fashion a remedy that is tailored to a specific situation in circumstances where imposing a more severe sanction may not be appropriate. For example, there may be situations where the suspension of registration or a cease trade order may not be warranted, but it is still appropriate to apply a sanction, with a view to protecting investors and deterring similar conduct. In some cases, a reprimand by itself may not be sufficient or appropriate. A general power to order compliance would give the Commission the flexibility to order a person or company to take certain steps in order to comply with requirements under Ontario securities law, or to cease contravening Ontario securities law.
- would lead to greater harmonization of the Commission's enforcement powers with those of other securities regulators. For example, the British Columbia and Saskatchewan Securities Commissions may each make an order that a person comply with or cease contravening the

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carrying out their duties and functions; rather, it authorizes the Commission to impose a sanction if inappropriate action that is contrary to the public interest is demonstrated.

[316] Amendments are shown in italics.

[317] *Supra* note 314.

[318] See powers under the Act: s. 104 (power to direct a person or company to comply with or cease contravening Part XX or related regulations); paragraph 127(1)4 (power to order that changes be made to the practices and procedures of a market participant); and paragraph 127(1)5 (power to order that a document or report required to be filed under the Act be provided to a person or company, not be provided to a person or company, or be amended).

> applicable Act, the regulations, a decision or by-law, rule or other regulatory instrument or policy.[319] The Saskatchewan Securities Commission may also order that a person or company comply with or cease contravening a written undertaking made to the Commission or the Director. The SEC may order a person to cease and desist from committing or causing a violation of a provision under the applicable securities legislation, require a person to comply with applicable provisions, and require future compliance.[320]

The Commission should have the power to make a general compliance order, similar to the power of the British Columbia and Saskatchewan Securities Commissions. In addition, we recommend that the Commission have the power, similar to that of the SEC, to order a person or company to take steps to ensure future compliance. This would allow the Commission, where a compliance order is appropriate, to send a clear message as to what is expected in terms of future compliance.[321]

(b) Power to Order Compliance with Direction, Decision, Order or Ruling of Recognized Self-Regulatory Organization or Exchange

The provisions with respect to compliance orders in both the British Columbia and Saskatchewan Acts also authorize the respective securities commissions to order a person or company to comply with or cease contravening a direction, decision, order or ruling made pursuant to a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.[322] This extension of the power to order compliance is particularly helpful in assisting these recognized bodies to enforce their self-regulatory powers. We believe that the inclusion of a specific authority in this regard underscores the public interest aspect of compliance with such directions, decisions, orders or rulings. Such a power also reinforces the principle in the Act that the Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized SROs.[323]

Recommendation:

We recommend that a new paragraph be created under subsection 127(1) of the Act, authorizing the Commission to order that a person or company:

- **comply with or cease contravening:**
  - **(i) Ontario securities law; or**
  - **(ii) a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.**
- **take steps to ensure future compliance with Ontario securities law, or a direction, decision, order or ruling made under a by-law, rule or other regulatory instrument or policy of a recognized SRO or exchange.**

20.3 Cease Trade

The Commission has the power under section 127 of the Act to make an order (a "cease trade order") that trading in any securities by or of a person or company cease permanently or for a specified period.[324]

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[319] British Columbia Act, clause 161(1)(a); and Saskatchewan Act, clause 134(1)(f).

[320] 1933 Act, s. 8A; and 1934 Act, s. 21C.

[321] The Commission has a similarly future-oriented authority under paragraph 127(1)4 of the Act, which is the power to order that a market participant submit to a review of their practices and procedures and institute any changes that may be ordered by the Commission.

[322] *Supra* note 319.

[323] The Act, s. 2.1.

The scope of a Commission cease trade order is linked to the definition of "trade," which includes the sale or disposition of securities or acts in furtherance of a sale or disposition of securities. However, the definition of "trade" or "trading" in the Act specifically excludes a purchase of securities.[325] This could result in a person or company subject to a cease trade order purchasing or accumulating securities during the cease trade period. Given the purpose of a cease trade order, this seems an illogical result. In our view, a cease trade order should apply to purchases of securities.

In order to ensure that cease trade orders serve their intended purpose, the Committee is of the view that paragraph 127(1)2 of the Act should be amended to provide that, for the purposes of a cease trade order, "trading" in any securities includes the purchase of securities.

Recommendation:

We recommend that paragraph 127(1)2 of the Act be amended to expressly provide that "trading" in securities for purposes of that paragraph includes the purchase of securities.

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[324] The Act, paragraph 127(1)2.

[325] Subsection 1(1) of the Act provides that "trade" or "trading" includes: (a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith; (b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system; (c) any receipt by a registrant of an order to buy or sell a security; (d) any transfer, pledge or encumbrancing of securities of an issuer from the holdings of any person or company or combination of persons or companies described in clause (c) of the definition of "distribution" for the purpose of giving collateral for a debt made in good faith; and (e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

Chapter 21: Which Existing Powers of the Court Should Be Expanded?

21.1 Maximum Fine and Term of Imprisonment under Section 122 of the Act

In addition to the power under section 127 of the Act to make orders in the public interest, the Commission may also prosecute a contravention of the Act before the court under section 122. Under the general penalty provision applicable to all offences, on convicting a person under section 122 the court may impose a fine, imprisonment for a term of not more than two years, or both a fine and imprisonment.[326] The maximum fine under section 122 is $1,000,000.[327] In the case of a conviction for contravention of the insider trading or tipping provisions, the maximum fine increases to the greater of $1,000,000 and triple the profit made or loss avoided by the person or company by reason of the contravention.[328]

(a) Subsection 122(4) of the Act – "By Reason of the Contravention"

Subsection 122(4) of the Act sets out the applicable fine in the case of a conviction for contravention of the insider trading or tipping provisions of the Act. The meaning of the phrase "by reason of the contravention" in subsection 122(4) has recently been called into question in a decision of the Ontario Superior Court.[329] Depending on the disposition of this decision on appeal, it may be necessary to amend section 122 to clarify the language and its intent.

(b) Maximum Fine and Term of Imprisonment

In considering whether the maximum fine and imprisonment term provisions in section 122 should be increased, the Committee looked at similar provisions in securities legislation in other provinces and in the United States.[330] We also considered the importance of ensuring that the Commission's powers are meaningful and that the penalties sought or imposed by the court and the Commission have a sufficient deterrent effect. We are concerned that the maximum fine and term of imprisonment under section 122 are not sufficient and believe that a higher maximum in each case would be appropriate in relation to conduct that is particularly egregious.

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[326] The Act, subsection 122(1).

[327] *Ibid.*

[328] The Act, subsection 122(4). Subsection 122(4) of the Act provides: "Despite subsection (1) and in addition to any imprisonment imposed under subsection (1), a person or company that is convicted of contravening subsection 76(1), (2) or (3) is liable to a fine of not less than the profit made or loss avoided by the person or company ***by reason of the contravention*** and not more than the greater of, (a) $1,000,000; and (b) an amount equal to triple the profit made or loss avoided by the person or company ***by reason of the contravention.***" [Emphasis added.]

[329] *R.* v. *Glen Harvey Harper*, Reasons for Judgment of Roberts, J., released January 7, 2002; leave to appeal granted by the Ontario Court of Appeal, January 14, 2002. In his decision, Roberts, J. found that in order to determine the amount of the fine under subsection 122(4) of the Act, following a conviction for insider trading, it must be shown that the profits made or loss avoided by the respondent were made or avoided "by reason of the contravention" of Ontario securities law. He stated that "[i]t is clear from the wording [of subsection 122(4)] that the Crown must prove more than simple profit or loss incurred in the prohibited trades", and that "[t]he contravention is not simply the result of trades carried out, but is linked to the material facts withheld. There must be evidence of the effect of such suppression of material facts on the market." The Court of Appeal granted leave to appeal on the issue of the application of subsection 122(4), as well as subsections 122(1), (5) and (6), following a conviction for insider trading.

[330] The general maximum fine is the same ($1,000,000) in the British Columbia Act and the Alberta Act. The Quebec Act contains a range of fines with a general maximum of $1,000,000 for certain specified offences. In the United States, under the 1934 Act there is a general maximum fine of $1,000,000 for a natural person and $2,500,000 for other than a natural person.

The last change to the general penalty provision under section 122 of the Act was made in 1987. At that time, the fine provision was increased from a maximum of $2,000 for an individual and $25,000 for a corporation, to a general maximum of $1,000,000. The maximum imprisonment term was increased from one year to two years. With the changes in the markets since that time, including the extent to which access to trading has opened up as a result of the Internet and other technological advances, there has been a corresponding increase in the opportunities for conduct that contravenes Ontario securities laws, as well as the number of investors (in particular, retail investors) who may be potential victims of such conduct. The Committee has considered these developments in conjunction with the types of offences that have been prosecuted under section 122 as well as the types of sentences that have been imposed in the case of convictions under section 122. We have also reviewed the imprisonment terms in securities legislation in certain other jurisdictions, in which the maximum terms range from three years to ten years.[331]

In our view, the maximum fine under the general penalty provision should be sufficiently large to be viewed as more than simply a licensing fee, and should be in an amount that will send a clear message that the conduct in question will not be tolerated. We recommend that the maximum fine under section 122 of the Act be increased from $1,000,000 to $5,000,000 and that this increase also be reflected in the provision for the maximum fine on a conviction for contravention of the insider trading or tipping provisions.

A review of sentencing decisions in Ontario in cases that have been decided from 1988 (i.e., following the increase in the maximum term of imprisonment provided under section 122 from one to two years) to 1996, indicates an increase in the number of sentences that include an imprisonment term, as compared with the 40 year period prior to 1988.[332] The imprisonment terms imposed in the majority of these cases were under the maximum term of two years. As might be expected, the courts reserve imposition of the maximum term for what would be considered to be the worst conduct in the circumstances.[333] One of the most recent examples of a significant imprisonment term under section 122 is the *Wall* case,[334] which involved a husband and wife who were charged with the distribution of and trading in securities contrary to Ontario securities law. In that case, the judge referred to the Reasons for Sentence for Jasper Naude in the *Sisto Finance* case,[335] in particular for the authority that the maximum sentence ought to be reserved for the worst sort of offence by the worst sort of offender.[336]

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[331] In the British Columbia Act, the maximum imprisonment term is three years (subsection 155(2)). In the Alberta Act, the maximum imprisonment term is five years less one day (subsection 194(2)). Under the 1933 Act, a person who wilfully violates the provisions of that Act or who wilfully makes an untrue statement in a registration statement that is misleading may face up to five years imprisonment (s. 24). Under the 1934 Act, in the case of a wilful violation of a prohibition or requirement in that Act or the making of a false or misleading statement in an application, report or other document required to be filed or in any undertaking in a registration statement, the maximum imprisonment term is 10 years (s. 32). In the United Kingdom, under the *Financial Services and Markets Act 2000, supra*, note 286, the maximum imprisonment term is seven years (s. 397 – misleading statements and practices offences).

[332] David Lang and Tim Moseley, "Emerging Trend Toward Jail Sentences for Securities Act Violations in Ontario," (January 1997).

[333] *Consortium Financial Inc., Consortium Properties Inc. and Pia Williamson,* (1992), 15 OSCB 4091. Ms. Williamson was sentenced to twenty-one months' imprisonment concurrent on forty-eight counts and in addition was fined a total of $350,000; *R.* v. *Sisto Finance NV et al.*, Reasons for Sentencing – Jasper Naude, Ontario Court (Provincial Division), September 28, 1994. Mr. Naude was sentenced to two years imprisonment.

[334] *R.* v. *Wall* (2001) 24 OSCB 763. Mr. Wall was given consecutive sentences of 18 and 12 months, for a total of 30 months imprisonment. Mrs. Wall received consecutive sentences of nine and 13 months, for a total of 22 months imprisonment.

[335] *Supra* note 333.

[336] More recently, in *R.* v. *117329 Ontario Ltd. and TAC International* (Reasons for Sentence, Ontario Court of Justice, January 25, 2002), the court sentenced one of the respondents, Douglas C. Walker, to 24 months in prison for nine convictions under the Act.

In view of developments in the marketplace over the past decade, we believe that where the conduct resulting in a conviction under section 122 is deliberate, egregious conduct that has caused serious harm to a significant number of investors, a court should have the flexibility to impose a monetary penalty and a term of imprisonment that adequately reflect the serious nature of the violations and the magnitude of the harm caused.

Having considered the background and principles discussed above, we believe that the maximum imprisonment term which may be imposed on conviction for an offence under section 122 of the Act should be increased to a term of five years less one day. This would provide the court with sufficient flexibility to fashion appropriate sentences in serious cases, and to send a significant message of deterrence in such cases.

Recommendations:

1. **We recommend that subsection 122(1) of the Act be amended to increase the maximum fine to $5,000,000 and to increase the maximum term of imprisonment to five years less one day.**

2. **We recommend that subsection 122(4) of the Act be amended to increase the maximum fine under that provision to "not more than the greater of (a) *$5,000,000*;[337] and (b) an amount equal to triple the profit made or loss avoided by the person or company by reason of the contravention."**

21.2 Proposed Authority to Order Restitution

The Committee is aware that it may be difficult, for many reasons, including time and resource issues, for investors to recover financial losses incurred as a result of the commission of an offence under section 122 of the Act. This concern was raised in a recent decision of the court in connection with a prosecution under section 122.[338] In that case the judge, in sentencing the respondents on their convictions for offences under the Act, noted with regret that the investors who were victims of the improper conduct in that case would have to pursue costly and complex litigation to recover their funds. In his reasons for sentence the judge recommended that the Act or the *Provincial Offences Act* be amended to permit the court hearing a matter under section 122 to order restitution.[339] We agree, and recommend that section 122 of the Act contain a power for the court to order restitution or compensation. We note that such a provision is found in the Alberta Act.[340] This would serve the important objectives of facilitating reparation for harm done to investors by providing an inexpensive manner of recovering their losses and making the wrongdoer directly responsible for the harm that he or she caused.

We understand that there may be procedural issues in connection with the power to make an order for restitution or compensation. These issues may include such matters as the identification of victims, the determination and proof of victims' losses and the collection of the amounts ordered to be paid. However, these are matters that can be dealt with by the court, in its discretion. The legislation may also deal with the collection of amounts ordered to be paid, for example, by providing that a restitution or compensation order may be enforced in the same manner as a judgment of the superior court.

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[337] Amendment is shown in italics.

[338] *R.* v. *Wall, supra* note 334, per Douglas, J.

[339] *Supra* note 336, at p. 773, where Mr. Justice Douglas stated: "I would further recommend that the Act or the *Provincial Offences Act* be amended so that the issue of restitution, forfeiture and seizure of property could be dealt with by the Court who tries this matter. As I understand it now, and it is conceded as a matter of law, I have no power to order restitution to the victims. Instead, costly, complex civil litigation is going to ensue unless the position of the defendants clearly changes. It ought, in my view, to be within my purview to order their assets seized, their assets sold, and restitution made to the people – having made the findings of fact I have."

[340] Subsection 194(7) of the Alberta Act, provides that: "If a person or company is guilty of an offence under this section, the court

(a) may make an order requiring the person or company to compensate or make restitution to the aggrieved person or company, and

(b) may make any other order that the court considers appropriate in the circumstances."

Recommendation:

We recommend that section 122 of the Act be amended to include a provision permitting the Ontario Court of Justice to make an order, where appropriate, that the defendant compensate or make restitution to persons who have suffered a loss of property as a result of the commission of an offence by the defendant.

Chapter 22: Other Enforcement Matters: Confidentiality of Investigations, Fraud and Market Manipulation, and Insider Trading

22.1 Confidentiality under Section 16 of the Act

One of the submissions to the Committee included a comment on section 16 of the Act.[341] Section 16 of the Act prohibits a person or company from disclosing the nature or content of an order for an investigation or financial examination except to his or her own counsel or pursuant to an order of the Commission authorizing such disclosure.[342] Under section 17, the Commission may make an order for disclosure of information referred to in section 16 where it considers that it would be in the public interest to do so. The commenter suggested that the Committee should review the scope, constitutionality and appropriateness of section 16. We understand the concern to be that this provision in the Act is too restrictive and that, for example, a person could not discuss the existence of an investigation or examination or any other knowledge or involvement he or she may have with respect thereto, with his or her employer, an officer or director of the employer or any other person who is not the person's own counsel.

The Committee has considered this concern and in particular, whether the provision for confidentiality contained in section 16 is appropriate.

The purpose of section 16 is two-fold:

(i) It protects the integrity of the investigation process. In the absence of such a provision, the Commission would have no control over the information that may be passed on regarding the investigation, including the fact that an investigation is being conducted. Public knowledge of such a fact or of particulars with respect to an investigation could:

- prejudice the reputation of the person or company involved, before a decision is made to proceed with a prosecution;
- result in collusion among witnesses who may discuss their evidence and/or assert blanket defences; and
- have an adverse effect on the capital markets.

(ii) It provides statutory protections to a witness who provides information or documents pursuant to a summons under section 13 of the Act.[343]

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[341] Simon Romano.

[342] S. 16 of the Act provides:

(1) Non-disclosure – Except in accordance with section 17, no person or company shall disclose at any time, except to his, her or its counsel,

(a) the nature or content of an order under section 11 or 12; or

(b) the name of any person examined or sought to be examined under section 13, any testimony given under section 13, any information obtained under section 13, the nature or content of any questions asked under section 13, the nature or content of any demands for the production of any document or other thing under section 13, or the fact that any document or other thing was produced under section 13.

(2) Confidentiality – Any report provided under section 15 and any testimony given or documents or other things obtained under section 13 shall be for the exclusive use of the Commission and shall not be disclosed or produced to any other person or company or in any other proceeding except in accordance with section 17.

[343] Under s. 13 of the Act, an investigator or examiner appointed by the Commission has the power to summon and enforce the attendance of any person and compel him to testify on oath or otherwise, and to summon and compel any person or company to produce documents or other things.

> In this latter case, for example, an employee may be reluctant to provide information to staff of the Commission on a voluntary basis in the context of an investigation of potential securities violations committed by his or her employer. The employee may only be willing to provide such information pursuant to a summons under section 13. The confidentiality requirements in section 16 and the provisions of section 17 with respect to when disclosure may be authorized provide some comfort to persons who are compelled to provide information in such circumstances.

In our view, the confidentiality provision in section 16 is an important aspect of the investigation provisions in the Act and serves the above-noted objectives of ensuring the integrity of the investigation process and protecting persons who provide information to the Commission in the course of an investigation. It is therefore important that the Commission be aware of the particular circumstances in which disclosure is sought, in order to be in a position to properly weigh the relevant interests involved i.e., the public interest in disclosure, against the interest in preserving the confidentiality of the investigatory process. This balancing is contemplated by section 17.

While we are sympathetic to the issues raised in this regard, we are concerned that taking away these important protections under section 16 is not the appropriate response. We note that parties can make an application under section 17 for an order authorizing the disclosure of the information requested. It might be helpful for the Commission to issue a policy statement providing interpretative guidance on the scope of the confidentiality provision in section 16 and the process for making an application under section 17. We welcome any suggestions that others may have in response to this issue.

Recommendation:

We recommend that the Commission issue a policy statement providing interpretative guidance on the scope of the confidentiality provision in section 16 of the Act and the process for making an application for disclosure under section 17 of the Act.

22.2 The Need for an Anti-Fraud and Market Manipulation Provision

(a) Fraud and Market Manipulation

The Act does not contain an express prohibition against fraudulent activity or market manipulation. Securities legislation in many jurisdictions includes fraud and market manipulation as specific contraventions against which securities regulators have the power to act.

While fraudulent activity or market manipulation are not expressly prohibited under the Act, the Commission does have the authority to deal with such conduct pursuant to its public interest jurisdiction under section 127. The Committee therefore considered whether it is necessary to have a specific provision addressing such conduct. In our view, the prohibition of fraud and market manipulation is so fundamental that it should be enshrined in the Act.[344] Such an amendment would complement rather than detract from the broad authority of the Commission under section 127 to exercise its enforcement powers in the public interest. Further, we believe that it should not be necessary for the Commission to rely on its public interest jurisdiction in respect of conduct that constitutes a fundamental abuse of capital markets. This conduct should be expressly prohibited under the Act.

Securities legislation in each of British Columbia, Alberta, and Saskatchewan contains express prohibitions against market manipulation.[345] The wording of the relevant provisions is similar and makes express reference to any conduct designed to create a false or misleading appearance of market activity or to establish an artificial price for a security. The provisions in the British Columbia and Alberta Acts also expressly prohibit fraud. The Committee notes that securities legislation in both the United States and the United Kingdom contains provisions which prohibit market manipulation. U.S. securities legislation prohibits fraud, the manipulation of the market price of a security, and any misleading trading activity.[346] The U.K. legislation contains a regime for market abuse and makes market manipulation an offence.[347] Prohibitions on market manipulation have also been established by RS Inc. and the IDA.[348]

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[344] See Chapter 5 of this Report.

[345] Alberta Act, s. 93; British Columbia Act, ss. 57 and 57.1; and Saskatchewan Act, s. 55.1.

In connection with the adoption of rules on December 1, 2001, creating a framework for ATSs the CSA has created a set of basic common trading rules that would apply across all marketplaces.[349] These Rules are set forth in National Instrument 23-101 Trading Rules, and Companion Policy 23-101 CP. Part 3 of the Trading Rules contains a provision that prohibits market manipulation and fraudulent activity.[350] In our view, such a provision properly belongs in the Act.[351]

While we support the CSA's approach to the prohibition against market manipulation and fraud, we recognize that certain aspects of the wording of the CSA provision may raise concerns. In particular, the use of the phrase "knows or ought reasonably to know" in the CSA provision introduces a negligence standard to what arguably ought to be a strict liability provision focussing on the effect of the conduct as opposed to the state of mind of the respondent. We also note the inherent inconsistency in the combination of a negligence standard (i.e., "ought reasonably to know") with an intentional act (i.e., "perpetrates a fraud").

We acknowledge that the *Criminal Code* contains prohibitions on certain manipulative and fraudulent practices affecting the public market generally or transactions on stock exchanges.[352] We do not think this prevents including a prohibition of the nature proposed by the Committee in the Act. Prosecutions under the *Criminal Code* may be distinguished from proceedings before the Commission on the basis of both the requirement to prove intent and the higher standard of proof required to secure a conviction under the *Criminal Code* ("proof beyond a reasonable doubt") and on the basis that the consequences for a breach of this provision in securities laws may be different from the penalties for the breach of the provisions in the *Criminal Code*.[353]

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[346] 1933 Act, clause 17(a); and 1934 Act, clause 9(a), clause 10(b), Rule 10 b-5 and clause 15(c).

[347] *Financial Services and Markets Act 2000, supra* Chapter 19, note 286, Part VII (ss. 118-130) and *Code of Market Conduct.*

[348] Universal Market Integrity Rules, s. 2.2 Manipulative and Deceptive Methods of Trading, and IDA, Policy No. 5.

[349] National Instrument 21-101 Marketplace Operation, National Instrument 23-101 Trading Rules, and OSC Rule 23-501 Designation as Market Participant (2001), 24 OSCB 10.

[350] Part 3 of the Trading Rules provides as follows:

3.1 Manipulation and Fraud

(1) A person or company shall not, directly or indirectly, engage in, or participate in any transaction or series of transactions, or method of trading relating to a trade in or acquisition of a security or any act, practice or course of conduct, if the person or company knows, or ought reasonably to know, that the transaction or series of transactions, or method of trading or act, practice or course of conduct

(a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security or a derivative of that security; or

(b) perpetrates a fraud on any person or company.

(2) In Alberta, British Columbia and Saskatchewan, instead of subsection (1), the provisions of the Alberta Act, the British Columbia Act and the Saskatchewan Act, respectively, relating to manipulation and fraud apply.

[351] While the wording of s. 3.1 of the Trading Rules is similar to wording in clause 10(b) and Rule 10(b)5 under the 1934 Act, the Trading Rules provision is broader because the reference to "an act, practice or course of conduct" is not tied to "a trade in or acquisition of a security," as in the case in the U.S. securities legislation. The importance of having a separate reference to "an act, practice or course of conduct" that is not connected to a trade or acquisition has been underscored by a recent decision of a federal appeals court in the United States which involved a broker who sold clients' securities and used the money for himself. The broker was convicted on criminal charges and served almost five years in prison. The SEC sued the broker and the court ruled that he should repay money he had taken from his clients' account. This ruling was reversed by the federal appeals court, whose decision was based on whether the fraud was committed "in connection with the purchase or sale of any security," as required in the U.S. securities legislation. That court ruled that there was nothing to indicate that the sales of the securities were not conducted legitimately; as such, they were incidental to the fraud, and accordingly the broker cannot be sued by the SEC for a violation of U.S. securities legislation. The U.S. Supreme Court heard the SEC's appeal of this decision on March 18, 2002. A decision is pending. (*SEC* v. *Zandford,* 238 F. 3d 559 (4th Cir. 2001), cert. granted, 70 U.S.L.W. 3091 (U.S. Nov. 9, 2001) (No. 01-147)).

(b) Misrepresentations

Securities legislation in British Columbia, Alberta, Saskatchewan and Manitoba contains provisions that prohibit a person or company, with the intention of effecting a trade in a security or an exchange contract, from making a statement that they know or ought reasonably to know is a misrepresentation[354] or is false, misleading or deceptive in a material manner.[355] In our view, the Act should contain a similar prohibition. However, we note that the provisions in the securities legislation in British Columbia, Alberta, Saskatchewan and Manitoba are directed at misrepresentations made "with the intent of effecting a trade" in a security or contract. This qualification circumscribes the ambit of the prohibition and we question whether this is the best approach. If a similar provision is included in the Act, we recommend that consideration should be given to the question of whether such a qualification is appropriate. We also recommend that this provision apply to any statements, whether written or oral.

Recommendations:

1. **We recommend that the Act be amended to expressly prohibit market manipulation and fraudulent activity.**

2. **We recommend that the Act be amended to include a provision prohibiting a person or company from making a statement, written or oral, that the person or company knows or ought reasonably to know is a misrepresentation. We also recommend that consideration be given to whether it is appropriate to limit the prohibition to statements made "with the intent of effecting a trade" in a security.**

22.3 Insider Trading

The Act contains a prohibition against trading and tipping activity by persons or companies that are in a "special relationship" with a reporting issuer, and requires insiders to report their trading activity. Specifically, the Act prohibits:

- trading of securities of a reporting issuer by persons or companies in a special relationship with the reporting issuer who have knowledge of a material fact or material change with respect to the reporting issuer before it has been generally disclosed ("insider trading"); and

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[352] *Criminal Code*, R.S. 1985, c. C-46, ss. 380 (Fraud/Affecting public market) and 382 (Fraudulent Manipulation of Stock Exchange Transactions).

[353] An offence under s. 380 of the *Criminal Code* can be an indictable offence or a summary conviction offence. For an indictable offence the maximum term of imprisonment under s. 380 is 10 years (or two years, if the value of the subject matter of the offence does not exceed $5,000). For a summary conviction offence, the maximum penalty is a fine of $2000 or six months imprisonment or both (see s. 787). An offence under s. 382 is indictable only, with a maximum term of imprisonment, on conviction, of five years. With respect to offences, the burden of proof on the prosecution in the case of an offence under the *Criminal Code* and an offence under s. 122 of the Act, is the same (i.e., beyond a reasonable doubt).

[354] Alberta Act, clause 92(3)(c); British Columbia Act, clause 50(1)(d); and Saskatchewan Act, subsection 44(3.1).

[355] *The Commodity Futures Act*, S.M. 1996, c. 73, clauses 49(2)(b) and (c).

- sharing of information with respect to a material fact or material change, where such information has not been generally disclosed ("tipping").

A person or company in a special relationship with a reporting issuer includes a person or company that is an "insider" of the reporting issuer. Insiders (which include directors or senior officers of the reporting issuer)[356] are required to file a report when they become an insider and when there is any change in their ownership or control over securities of the reporting issuer.[357]

A number of commenters on this issue expressed the view that there should be more emphasis on detection and enforcement with respect to insider trading violations,[358] including in the area of monitoring and auditing of trading prior to the public announcement of certain events.[359] The main concerns in connection with insider trading appear to relate to reporting and transparency of reporting and the amount of emphasis which should be placed by the Commission on surveillance and enforcement of insider trading prohibitions.

We have addressed enforcement issues, generally, in connection with our recommendations for additional enforcement powers of the Commission, which are discussed in Chapters 19, 20 and 21. Many of these recommendations, if implemented, will equip the Commission and the courts to better deal with insider trading contraventions. For example:

- We have recommended that the Commission have the power, under section 127 of the Act, to impose an administrative fine of up to $1,000,000.
- We have recommended that the Commission have the power to order that a person comply with or cease contravening Ontario securities law and take steps to ensure future compliance. This power could be used by the Commission to supplement other orders it may make in the context of administrative hearings under section 127 of the Act in connection with insider trading contraventions.
- We have also recommended, in connection with section 122 of the Act, that the maximum fine provided for under that section be increased from $1,000,000 to $5,000,000 (with a corresponding increase in connection with insider trading conventions) and that the maximum term of imprisonment provided for under that section be increased from two years to five years less one day. The potential for a significant fine and term of imprisonment would add to the deterrent effect of the application of the Commission's enforcement powers to insider trading contraventions.

We also note that there are several different enforcement avenues available to the Commission for alleged insider trading violations. It can commence a quasi-criminal proceeding under section 122 of the Act. It can also commence administrative proceedings before the Commission in which the Commission may, under section 127, make one or more orders in the public interest. Finally, the Commission may apply to the Superior Court of Justice for one or more civil enforcement orders. Traditionally, the Commission has pursued alleged insider trading violations as quasi-criminal offences. We note, however, that a section 122 proceeding is subject to a higher standard of proof (i.e., proof beyond a reasonable doubt versus proof on a balance of probabilities) and a more onerous evidentiary burden. As a practical matter, we would suggest that, in appropriate cases, the

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[356] The Act, subsection 1(1), definition of "insider".

[357] The Act, ss. 107, 108 and 109.

[358] Investment Counsel Association of Canada, Simon Romano, Ontario Teachers' Pension Plan Board and TSX Venture.

[359] TSX Venture.

Commission consider pursuing these alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.

Finally, we examined the insider trading civil liability provisions of the Act. The Act only confers a cause of action for improper insider trading on persons who purchase or sell securities from or to the offending insider trader (privity requirement).[360] One practitioner has stated that:

> [i]n an active secondary market, it will usually be difficult for an investor to demonstrate the direct relationship required by the statute. More importantly, even if an investor can show the necessary link, the link itself will be no more than a matter of happenstance. The investor who is entitled to recover is no different than other investors trading on the same side of the market at approximately the same time, whose shares are not fortuitously purchased or sold by the insider. The current legislative provisions thus create an unrealistic remedy that even when available, is based on arbitrary distinctions resulting from mere chance.[361]

We recommend that the CSA consider as part of its proposed Civil Liability Amendments whether it would be desirable to broaden existing insider trading civil liability provisions by deleting the privity requirement.

Recommendations:

1. **We suggest that, in appropriate cases, the Commission consider pursuing alternative enforcement mechanisms available under sections 127 and 128 of the Act as a regulatory response to illegal insider trading.**
2. **We recommend that the CSA consider as part of its proposed Civil Liability Amendments whether it would be desirable to broaden existing insider trading civil liability provisions.**

22.4 Insider Reporting

With respect to insider reporting, we note that effective October 29, 2001, the Commission and other members of the CSA implemented SEDI.[362] The objective of SEDI is to allow insiders of most reporting issuers to securely file insider reports in electronic format over the Internet. For the investing public, the new system will make selected data on insiders available to them through the SEDI website. It is anticipated that the implementation of SEDI will result in faster and more efficient dissemination of reported information. SEDI will also facilitate, among regulators, a co-ordinated approach to reviewing insider reports and will provide an ability to effectively monitor compliance with insider reporting requirements.[363] At present, insider reports are required to be filed within 10 days of the date of the trade. Once SEDI is fully operational the CSA should consider further reducing the time period for filing insider reports from the current 10 days. Electronic filings should facilitate more current timely disclosure of insider trades.

Several commenters expressed concern with respect to transactions through which insiders effectively "dispose" of their securities in an issuer, without triggering insider reporting obligations.[364] Examples provided by these commenters include lending or derivative arrangements and the use of structured financial products, which enable insiders to trade their securities "synthetically" or through a third party, in the context of a hedging transaction, without being required to report the transaction in all circumstances. The SEDI reporting form for insider transactions (Form 55-102F2) specifically requests information with respect to transactions in third party derivatives. This information is not specifically identified in the existing paper form of the insider report. We are advised that this has caused some confusion in the marketplace and has been misconstrued as a new reporting requirement. We understand that the CSA's intention was to facilitate insider reporting of trades in exchange-traded or over-the-counter options or other derivatives, where reporting of such trades is already mandated by securities legislation.

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[360] The Act, s. 134 ("liable to compensate the seller or purchaser of the securities").

[361] See the dissenting statement of Philip Anisman, TSE Committee on Corporate Disclosure, *Final Report, Responsible Corporate Disclosure – A Search for Balance* (March 1997) at page 112.

[362] Notice of National Instrument 55-102, Forms 55-102F1, 55-102F2, 55-102F3, 55-102F4, 55-102F5 and 55-106 F6, Companion Policy 55-102CP – System for Electronic Data on Insiders (SEDI), (2001) 24 OSCB 4414. The SEDI system is currently unavailable due to technical difficulties.

[363] *Ibid.*

[364] The IDA, Simon Romano, and Ontario Teachers' Pension Plan Board.

The Committee is aware that issues have arisen in connection with transactions involving third party derivatives and whether these must be reported. An example of this would be equity monetizations.[365] Equity monetization transactions give rise to regulatory issues in the context of insider reporting, insider trading, escrow and hold periods. We understand that the CSA recently initiated a project to review these issues generally. We believe that insiders should be required to report these types of transactions, so that the public may be made aware of the extent of the insider's economic exposure to the issuer and any effective change in, or disposition of, this exposure. We encourage the work of the CSA and emphasize the need for transparency of insider reporting in this regard. We also stress the importance of dealing with these issues on a national basis.

Recommendations:

1. **We recommend that the CSA consider further reducing the time period for filing insider reports (from the current requirement to file within 10 days of the date of the trade) once SEDI is fully operational.**

2. **We recommend that Ontario securities law be amended to require insiders to report any effective change in, or disposition of, their economic interest in an issuer.**

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[365] An equity monetization is a transaction through which a security holder is put into an economic position which is similar to that of having sold the subject securities, without actually selling them, or triggering an obligation to report a trade.

Appendix A: Glossary

"1934 Act" means the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq.

"1994 Amendments" means the *Securities Amendment Act*, 1994, S.O., c. 11, which gave the Ontario Securities Commission rulemaking power.

"Act" means the Securities Act (Ontario), R.S.O. 1990, c.S.5.

"AcSB" means the Canadian Accounting Standards Board.

"AIF" means Annual Information Form.

"Alberta Act" means the *Securities Act* (Alberta), R.S.A. 2000, c. S-4.

"Allen Committee" means The Toronto Stock Exchange Committee on Corporate Disclosure established in June 1994 to review and comment on the adequacy of continuous disclosure by public companies in Canada and to determine whether additional remedies should be available to injured investors or regulators if companies fail to comply with the rules.

"Allen Report" means the report issued in March 1997 by The Toronto Stock Exchange on Corporate Disclosure entitled *Responsible Corporate Disclosure, A Search for Balance.*

"Analysts Standards Committee" refers to the Securities Industry Committee on Analysts Standards formed in 1999 by the IDA, the TSX and TSX Venture.

"AcSOC" means the Accounting Standards Oversight Council.

"ATS" means Alternative Trading System.

"Bank Act" means the *Bank Act*, S.C. 1990, c. 46.

"Blue Ribbon Committee" means the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees sponsored by the NYSE and the NASD at the request of the SEC.

"British Columbia Act" means the *Securities Act* (British Columbia), R.S.B.C. 1996, c. 418.

"Bulletin" means the Ontario Securities Commission Bulletin.

"CBCA" means the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44.

"CBO" means the Canadian Banking Ombudsman.

"CDN" means the Canadian Dealing Network.

"CDNX" means the Canadian Venture Exchange Inc.

"CD Team" means the Continuous Disclosure Team of the Ontario Securities Commission.

"CICA" means the Canadian Institute of Chartered Accountants.

"Civil Liability Amendments" refers to the draft amendments published by the CSA proposing a statutory civil liability regime in CSA Notice 53-302 – Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change" ((2000), 23 OSCB 7383).

"Commission" means the Ontario Securities Commission.

"Committee" means the Five Year Review Committee.

"CSA" means the Canadian Securities Authorities.

"CUB" means the Canadian Unlisted Board.

"CVMQ" means the Commission des valeurs mobilières du Québec.

"Daniels Committee" means the Joint Task Force on Securities Regulation established by the Ministry of Finance and the Ontario Securities Commission in October 1993 to review and make recommendations regarding the legislative framework for the development of securities policy in Ontario.

"Daniels Report" means the report by the Task Force on Securities Regulation, Responsibility and Responsiveness – Final Report of the Ontario Task Force on Securities Regulation (1994), 17 OSCB 3208.

"Dey Committee" means the TSE Committee on Corporate Governance in Canada established in September 1993 to conduct a study of corporate governance in Canada and to make recommendations to improve the manner in which Canadian corporations are governed.

"Dey Report" refers to the report issued by the Dey Committee in 1994 entitled *"Where Were the Directors? Guidelines for Improved Corporate Governance."*

"ECA" means the *Electronic Commerce Act, 2000* (Ontario), S.O. 2000, c. 17.

"FCAC Act" refers to the *Financial Consumer Agency of Canada Act*, S.C. 2001, c. 9.

"FSA" means the Financial Services Authority of the United Kingdom.

"FSCO" means the Financial Services Commission of Ontario.

"GAAP" means Generally Accepted Accounting Principles.

"G-7" means the group of seven countries consisting of the United States, Japan, Germany, France, Italy, Britain and Canada.

"IAS" means international accounting standards promulgated by IASC.

"IASC" means the International Accounting Standards Committee.

"IDA" means the Investment Dealers Association of Canada.

"IDS" means the Integrated Disclosure System.

"IFAC" means the International Federation of Accountants.

"Insurance Act" means the *Insurance Act*, R.S.O. 1990, c. I.8.

"IOSCO" means the International Organizations of Securities Commissions.

"Joint Forum" means the Joint Forum of Financial Market Regulators which was established by the CSA, the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities and is made up of representatives of those organizations. Its goal is to co-ordinate and streamline the regulation of financial products and services across Canada.

"Joint Forum Task Force on Dispute Resolution" means the Task Force on Dispute Resolution created by the Joint Forum of Financial Market Regulators in Canada.

"Kimber Report" means the Report of the Attorney General's Committee on Securities Legislation in Ontario (Ontario: Queen's Printer, 1965).

"MFDA" means the Mutual Fund Dealers Association.

"MJDS" means the multijurisdictional disclosure system.

"MD&A" means Management's Discussion and Analysis.

"NASD" means the National Association of Securities Dealers.

"NASDAQ" means the National Association of Securities Dealers Automated Quotation System.

"NYSE" means the New York Stock Exchange.

"OBCA" means the *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16.

"OSFI" means the Office of the Superintendent of Financial Institutions.

"1990 Proposals" means the set of proposals entitled Proposals for Amendments to the Securities Act (Ontario) in the Areas of Investigations, Enforcement and Remedies, (1990) 13 OSCB 405.

"QATRS" means a Quotation and Trade Reporting System.

"Quebec Act" means the *Securities Act* (Quebec), R.S.Q. c. V-1.1.

"Reformulation Project" means the process began in 1994 by the Ontario Securities Commission to review all of its existing policy statements, notices and blanket rulings in order to either reformulate them as rules, policies or staff notices or eliminate them.

"RS Inc." means Market Regulation Services Inc.

"Saskatchewan Act" means the *Securities Act* (Saskatchewan), R.S.S. 1988-89, c. S-42.2.

"Saucier Committee" refers to the Joint Committee on Corporate Governance sponsored in July 2000 by the TSX, TSX Venture and the CICA, and chaired by Guylaine Saucier.

"Saucier Report" means the Final Report of the Joint Committee on Corporate Governance: Beyond Compliance: Building a Governance Culture (November, 2001).

"SEC" means the U.S. Securities and Exchange Commission.

"SEDAR" means System for Electronic Document Analysis and Retrieval.

"SEDI" means System for Electronic Data on Insiders.

"SRO" means self-regulatory organization.

"TSE" means The Toronto Stock Exchange (now known as the "TSX").

"TSX" means The Toronto Stock Exchange (formerly referred to as the "TSE").

"TSX Guidelines" means the guidelines in section 474 of the TSX Company Manual for Effective Corporate Governance.

"TSX Venture" refers to the TSX Venture Exchange and its predecessor, the Canadian Venture Exchange, or "CDNX".

"UCC" means the *Uniform Commercial Code.*

"Wallman Report" means the Report of the Advisory Committee on the Capital Formation and Regulatory Processes dated July 24, 1996.

"Zimmerman Committee" means the committee of the Investment Dealers Association of Canada established in 1996 to review take-over and issuer bid time limits.

Appendix B: Issues List

Five Year Review of Securities Legislation in Ontario – Securities Review Advisory Committee's Request for Comments

Introduction:

The Securities Act (Ontario) (the "Act") provides that, every five years, the Minister of Finance will appoint an advisory committee to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission ("OSC" or the "Commission") and the legislative needs of the Commission. Finance Minister Ernie Eves has established the first such committee (the "Securities Review Advisory Committee" or the "Committee") to conduct this review. Minister Eves has directed the Committee, in discharging its mandate, to ensure that securities legislation in Ontario is up-to-date and that it properly enables the Commission to proactively enforce clear standards to protect investors and foster a fair and efficient marketplace. The full text of Finance Minister Eves' press release announcing the formation of the Committee is contained at Appendix 1 to this Request for Comments.

The Chair of the Committee is Purdy Crawford Q.C., counsel to Osler, Hoskin & Harcourt LLP. Other members of the Committee are Carol Hansell, partner with Davies, Ward & Beck; William Riedl, president and CEO of Fairvest Securities Corporation; Helen Sinclair, CEO of BankWorks Trading Inc; David Wilson co-chairman and co-CEO at Scotia Capital; and Susan Wolburgh Jenah, Commission general counsel. The Committee has retained Anita Anand, Assistant Professor, Faculty of Law, Queen's University and Janet Salter, lawyer with Osler, Hoskin & Harcourt LLP to assist the Committee in its review. They will be assisted by Rossana Di Lieto, Legal Counsel, Commission.

Request for Comments:

The Committee is seeking input from market participants in connection with its review of the legislation, regulations and rules relating to matters dealt with by the Commission. To stimulate input, the Committee has prepared an illustrative set of questions (the "Issues List") which it proposes to consider. The Issues List is published in the April 28, 2000 edition of the Ontario Securities Commission Bulletin and can be accessed at the Commission's website at www.osc.gov.on.ca.

The Issues List is intended as a catalyst for discussion only. Commenters are welcome to raise other matters that they believe fall within the Committee's mandate to consider. The Committee recognizes that certain matters may currently be under consideration by regulators or other entities but welcomes input on such matters as well.

By its very nature, the Issues List might give the impression that the Committee intends to recommend a more complex and comprehensive regulatory regime than currently exists. This is not the intention of the Committee. The Committee believes that it is necessary to find compelling public policy grounds to justify regulation. The Committee believes that where regulation is necessary, in many instances, self-regulation is desirable.

Draft Report:

The Committee proposes to prepare a report outlining the results of its consultation process and its recommendations. The report will be based in part on matters raised in the Issues List, but the Committee is not bound to address all items raised on the List, and may address other matters raised by commenters. The Committee will first publish the report in draft for comment.

Comments:

Interested parties are invited to make written submissions with respect to the Issues List or other matters which commenters wish to raise. Submissions received by June 9, 2000 will be considered by the Committee. The following guidelines provide general information about making submissions to the Committee and the manner in which the Committee will handle the submissions.

Form of Submissions

Submissions should be sent in duplicate to:

Purdy Crawford
Osler, Hoskin & Harcourt LLP
Barristers & Solicitors
Box 50, 1 First Canadian Place
Toronto, Ontario M5X 1B8

A diskette containing the submissions should also be submitted.

All submissions should indicate a contact person and contact details (return address, telephone and fax numbers, e-mail address), who would be available to respond to inquiries from the Committee in connection with the submission.

Comment letters submitted in response to the Request for Comments will be placed on the public file and form part of the public record, unless confidentiality is requested. Since the Committee wishes to carry out its responsibilities in an open and accessible manner, requests for confidentiality are discouraged and should be limited to situations involving only highly confidential information where disclosure could be detrimental. Persons submitting comment letters should be aware that the press and members of the public may be able to obtain access to any comment letter, even if the Committee does not put the letter on the public file.

Consultation Process

The Committee does not intend to hold formal public hearings concerning the Issues List. Persons or entities making submissions may be approached by the Committee or its staff to expand upon their submissions or to enable Committee members to make further inquiries.

Dated: April 28, 2000.

Securities Review Advisory Committee Issues List

Commenters are encouraged to refer to the Commentary and Additional Questions (the "Commentary") attached to this Issues List for background information and elaboration on certain of the issues outlined below.

I. Principles Underlying Securities Regulation
Fundamental Principles
The Closed System

II. Focus and Scope of Legislation
General
Regulation of Registrants
Self-Regulatory Organizations and Other Market Intermediaries
Tiered-Holding System
Continuous Disclosure Obligations
Mutual Funds
Shareholder Communications and Take-over Bids
Enforcement

III. Impact of Regulatory Harmonization and Globalization Trends

IV. Impact of Technology

V. Mandate and Role of the Commission

I. Principles Underlying Securities Regulation

Fundamental Principles

1. Does the current statutory regime effectively balance the dual objectives of protecting investors and fostering efficient capital markets?

2. Securities regulation could be based on a statute that sets out broad principles and standards of market behaviour, as well as powers to deal with contravention of these standards. In this model, any detailed rules that might be required would be reflected in subordinate instruments, such as rules. Such a model would be flexible in its ability to adapt to market changes and trends. Is such a model desirable? If so, what broad principles and standards of market behaviour should be included in the legislation?

3. Does the Act[1] adequately account for the marketplace shift from trade execution towards "assets under management" and "advice giving"? Should these activities be regulated differently than they are now?

The Closed System

4. Is there a simpler approach that could replace the closed system but which would still protect investors, foster fair markets and maintain an appropriate balance between private and public offerings?

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[1] Securities Act, R.S.O. 1990, C. S.5.

5. What exemptions from the prospectus and/or registration requirements of the Act should be added or removed?

6. Securities transactions are often artificially structured to avoid hold periods under the Act which result from the closed system. Should another approach be adopted to prevent sophisticated persons from being able to structure transactions to avoid control block restrictions?

7. The legending of security certificates to indicate and give notice of restrictions on resale is a concept that is incompatible with the holding of securities in book based form. In view of this reality, as well as the fact that securities are fungible, legends on certificates may not be transparent or effective. What alternatives exist, assuming the closed system continues in effect?

II. Focus and Scope of Legislation

General

8. The regulation of financial services in Canada is structured around the nature of the institution (bank, insurance company, dealer) which is providing the service, rather than around the service itself. This has produced a rising number of circumstances where similar activities or products are regulated in a different fashion, depending on the nature of the financial conglomerate offering the product or service.

(a) Should securities regulation be amended to reflect the shift in the way financial markets are structured? For example, are the current exemptions from regulation of securities based on the issuer still appropriate?

(b) Should legislation include some formal requirement to facilitate the coordination between financial services regulators?

9. Should financial services regulators, including self-regulatory organizations ("SROs"), have the ability to handle consumer complaints through ombudsman or arbitration schemes? If so, what type of complaint handling schemes would be desirable in Ontario?

10. Should the Act be integrated with the Commodity Futures Act[2] and the Commission be given explicit jurisdiction over derivatives?

Regulation of Registrants

11. Currently, securities legislation requires dealers to be registered when they "trade in securities in the capacity of principal or agent".[3] Rather than focusing on whether or not a dealer is "trading," should the requirement to be "registered" be based on whether the dealer is engaged in, or is holding itself out as being engaged in, the business of buying, selling or otherwise advising with respect to securities?

12. Largely as a result of the Internet and related technological developments, investors have direct access to the markets today.

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[2] R.S.O. 1990. Ch. c. 20.

[3] Subsection 1(1) Definition of "Dealer" and subsection 25(1).

(a) What is the role of an "intermediary" in the context of disintermediated markets? For example, are there activities or transactions that should be exempt from the need to involve a regulated intermediary? If so, what are they?

(b) To what extent do traditional obligations of registrants such as assessment of suitability and "know-your-client" need to be re-examined in the context of a disintermediated and electronic trading environment? In this context, do distinctions need to be drawn between registrants that are under a fiduciary obligation to their clients versus those that are not?

13. Should the concept of universal registration be eliminated? Alternatively, how might the current multiple categories of registration be simplified and streamlined?

Self-regulatory Organizations and Other Market Intermediaries

14. The Act recognizes the important role played by recognized SROs and establishes that the Commission should, subject to an appropriate system of supervision, rely on these SROs. In view of the critical role played by these recognized SROs:

(a) Should the legislation be more explicit in recognizing that SROs have the authority to enforce their own rules and ensuring that they have the necessary tools to do so?

(b) Should recognized SROs have the authority and obligation to enforce compliance not only under their own rules but also Ontario securities law?

(c) Should securities law permit or prohibit an SRO from acting as a trade association?

15. Currently stock exchanges are precluded from carrying on business in Ontario unless recognized by the Commission.[4] Should other SROs, clearing agencies, and quotation and trade reporting systems be required to obtain recognition from the Commission?

16. Does the Act need to address in a more comprehensive fashion the SRO regulatory oversight function and provide for the necessary tools to ensure that such oversight remains effective?

17. Should the provision of custody services be a registrable activity or be subject to express requirements under the Act?

Tiered-Holding System

18. Canadian law governing transfers and secured lending transactions involving investment securities relies upon concepts of possession and delivery of security certificates to complete a transfer or to perfect a pledge. The use of these concepts reflects an era when actual physical delivery of security certificates was the normal method of settling transactions and perfecting pledges. The concepts of actual or deemed possession and delivery work less well, however, when applied to the modern indirect holding system which now exists in

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[4] Subsection 21(1).

Canada. How should Ontario and other Canadian provinces modernize laws that govern the holding, transferring and pledging of securities held through the indirect holding system? How closely should Article 8 of the U.S. Uniform Commercial Code ("Revised Article 8") be followed?[5]

Continuous Disclosure Obligations

General

19. In response to the increasing importance of the secondary markets, the Commission has taken action on a number of fronts as outlined in the Commentary.

(a) Does the present structure of the Act adequately respond to the increasing importance of the secondary market? For example, a successful continuous disclosure monitoring system requires effective regulatory tools to deal with misleading or inappropriate disclosure practices to encourage issuer compliance. Are additional powers or remedies needed to facilitate the Commission's enhanced role in monitoring continuous disclosure?

(b) Are there any changes which should be made to the Act to improve the content, quality and timing of continuous disclosure?

(c) Should there be statutory civil liability for misrepresentations in continuous disclosure documents?

Materiality

20. Securities legislation currently focuses on "material facts" and "material changes" for various purposes such as prospectus disclosure and continuous disclosure obligations, insider trading rules and proxy solicitation rules.

(a) Is the existing standard of materiality for purposes of triggering continuous disclosure obligations appropriate?

(b) Would a focus on "material information" be more appropriate regardless of whether or not there has technically been a "change" in the issuer's affairs?

(c) Should Ontario securities law require the reporting of specified events rather than attempting to specify whether information meets a certain standard of materiality?

Financial Disclosure

21. The Act requires financial statements of reporting issuers to be prepared in accordance with generally accepted accounting principles (GAAP) and audited and reported upon in accordance with generally accepted auditing standards (GAAS).[6] The Act also provides the Commission with specific rulemaking powers with respect to the accounting and auditing standards to be applied in financial statements and auditors' reports filed with the Commission.[7] To date, the Commission has chosen not to exercise its rulemaking powers in any manner that overrides the standards set out in the CICA Handbook.

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[5] See Commentary 18, *infra.*

[6] *Securities Act*, R.R.O. 1990, Regulation 1015, Section 2.

(a) Are traditional GAAP/GAAS financial statements adequate in today's markets? For example, should the current accounting principles applicable to compensation options be reviewed to ensure that the accounting treatment of options conforms to standards of good corporate governance?

(b) What reforms should be adopted to facilitate uniform international accounting standards?

Selective Disclosure

22. Is the practice of "selective disclosure" an issue that should be addressed by regulation? If so, what regulation would be appropriate? Is the approach of the U.S. Securities and Exchange Commission (the "SEC") one that should be adopted?

23. How do concerns with respect to selective disclosure impact on traditional views with regard to "road show" sentations?

Mutual Funds

24. Are any reforms necessary under the Act to improve fund governance? Should there be a requirement for an independent board? If so, what responsibilities should be attributed to the board? What should the powers of the board be in the event it does not agree with management?

25. Should fund managers be regulated or be required to be registered?

26. As part of the proposal to introduce statutory civil liability for misrepresentations in continuous disclosure documents, the CSA is proposing to change the definition of "material change" when used in relation to mutual funds to parallel the definition of "significant change" in National Instrument 81-102 Mutual Funds.[8]

Should this revised standard for mutual funds be reflected in the Act?

27. Since 1997, the CSA have been working with the Investment Dealers Association of Canada and The

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[7] Clause 143(1)25.

[8] Under the draft legislation "material change" when used in relation to an issuer that is an investment fund, means,

(i) a change in the business, operations or affairs of the issuer that would be considered important by a reasonable investor in determining whether to purchase securities of the issuer, or in determining whether to continue to hold securities of the issuer, or

(ii) a decision to implement a change referred to in subparagraph (i) made,

(a) by senior management of the issuer who believe that confirmation of the decision by the board of directors or such other persons acting in a similar capacity is probable, or

(b) by senior management of the investment fund manager of the issuer who believe that confirmation of the decision by the board of directors of the investment fund manager of the issuer or such other persons acting in a similar capacity is probable.

Investment Funds Institute of Canada to facilitate the establishment of a self-regulatory organization for distributors of mutual funds in Canada. Moreover, in May, 1998 the CSA promulgated rules governing mutual fund sales practices. More recently, the CSA published a position paper which sets out acceptable ways in which securities firms will be expected to structure themselves for the purposes of distributing securities to the investing public. Are there additional reforms that are necessary or desirable in the area relating to the distribution of investment funds?

Shareholder Communications and Take-over Bids

28. Proposed amendments to the Canada Business Corporations Act[9] have been introduced which are intended to encourage and facilitate communications among shareholders. The SEC has also amended its proxy rules to foster more open communication among shareholders.[10] Are there complementary reforms that are necessary or desirable under the Act or Business Corporations Act (Ontario)?[11]

29. Recently the Committee of the Investment Dealers Association of Canada to Review Take-Over Bid Time Limits (the "Zimmerman Committee") issued a report which recommended a number of changes in the regulation of take-over bids. Many CSA jurisdictions, including Ontario, have now enacted legislation, subject to proclamation, which would implement the recommendations of the Zimmerman Committee.[12]

(a) Are additional reforms necessary or desirable in the area of take-over bid or issuer bid regulation?

(b) Does the current legislation properly capture those transactions that should be subject to take-over bid regulation?

Enforcement

30. Are the current detection and disclosure provisions with respect to insider trading sufficient? Does the Commission need additional enforcement authority in dealing with insider trading?

31. Securities legislation in many jurisdictions includes fraud and market manipulation as specific contraventions against which securities regulators have the power to act. Should such offences be expressly included in the Act?

III. Impact of Regulatory Harmonization and Globalization Trends

32. While securities regulation continues to be administered provincially, there has been an increasing trend towards inter-provincial co-operation and harmonization in the administration of securities regulation across Canada.

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[9] R.S.C. 1985, c C-44.

[10] Regulation of Communications Among Shareholders, 17 CFR Parts 240 and 249, Release No. 34-31326170 and Regulation of Takeovers and Security Holder Communications, 17 CFR Parts 200, 229, 230, 232, 239 and 240, Release No. 33-7760, 34-420055.

[11] R.S.O. 1990, c. B. 16.

[12] In Ontario, the amendments proposed by the Zimmerman Committee were included in the *More Tax Cuts for Jobs, Growth and Prosperity Act, 1999* which received Royal Assent on December 14, 1999.

(a) Is the mutual reliance review system an effective means of achieving inter-provincial co-operation and harmonization?

(b) Are there other areas of securities regulation where it would be beneficial to have a more "seamless" form of regulation between provincial securities regulators?

(c) Should the Act explicitly recognize the ability of the Commission, in appropriate circumstances, to delegate functions to other securities regulators in Canada or elsewhere?

33. Capital markets are becoming more international in character but regulation still exists only at the domestic level. The transnational nature of global trading has removed securities transactions from the full jurisdictional reach of domestic regulation. As discussed in the Commentary, this is an issue that the European Community has recently addressed. How does one ensure proper regulation from a domestic perspective without compromising global competitiveness for issuers and investors?

IV. Impact of Technology

34. The Act is "paper-based" and is oblivious to the emergence of the Internet and E-commerce transactions. Are changes to the legislation necessary in view of technological developments for instance with respect to continuous disclosure obligations, insider trading reporting, prospectus offerings etc.?[13]

35. Is any new regulation required to address the use of the Internet as a means for issuers to communicate with their shareholders? For example, is regulation required to enable shareholders to vote online and similarly to receive on demand, or access from a central website, electronically-transmitted press releases and public filings?

36. The Internet has made it possible for issuers to sell shares directly to the public without the use of an under writer. Direct purchase plans allow individuals to contribute through a monthly bank account debit to the purchase of an issuer's shares. In the U.S., Home Depot has currently adopted this practice. A simplified prospectus in plain English is online and incorporates by reference its annual and quarterly financial reports. If Canadian issuers begin to raise a portion of their financing in this way, should the Act and regulations be changed to account for this type of offering?

37. The current shareholder communication model reflected in the Act mandates that a reporting issuer "deliver" to security holders specific corporate information. In light of the communication opportunities presented by the Internet and the availability of corporate disclosure through SEDAR is this communication model still appropriate? For example, should securities regulators go further than National Policy 11-201 Delivery of Documents by Electronic Means[14] and shift the onus on to shareholders to request information, in the absence of which they will be deemed to have requested that such information not be delivered?

38. In the Internet age, determining the limits of jurisdiction raises significant issues relating to the scope of the Commission's jurisdiction. Do changes need to be made to the Act to address issues of extra-territoriality that arise in the context of disclosure, offerings and transactions completed on the Internet?

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[13] See NP 47-201 *"Trading Securities Using the Internet and Other Electronic Means"* (1999) 22 OSCB 8170.

[14] (1999) 22 OSCB 8156. The substance and purposes of NP 11-201 is to state the views of the CSA on how obligations imposed by securities legislation to deliver documents can be satisfied by electronic means.

V. Mandate and Role of Commission

39. The Commission received rulemaking authority approximately five years ago.

(a) Is the rulemaking process an effective way of regulating?

(b) In light of recent experiences, are there changes that should be made to the rulemaking process? For example, should the Commission be granted flexibility and discretion when republication is warranted?

40. Are the current enforcement powers of the Commission appropriate?[15] Are there any additional enforcement powers that should be granted to the Commission?

41. Is the Commission's mandate as reflected in the legislation appropriate in today's market?[16] Should the Commission's mandate recognize the importance of securing Ontario's place within global and competitive securities markets?

42. The Act sets out "principles" for the Commission to consider in discharging its statutory mandate.[17] In today's market, are these principles appropriate, relevant and sufficient as bases on which the Commission should discharge its responsibilities?

Commentary and Additional Questions

Further explanation, examples and additional questions pertaining to matters raised in the Issues List are outlined below. The numbers of the items in this Commentary follow the numbering adopted in the Issues List.

I. Principles Underlying Securities Regulation

Fundamental Principles

3. The Act is structured to regulate "trades" and "distributions". Increasingly, however, revenue is gained not only from trade execution, but also from providing advice, unbundling services (i.e., advice, execution, clearing and settlement) and administering assets under management.

The Closed System

4. The closed system governs exempt distributions under the Act. Introduced in 1979, the system was in part intended to replace the concept of "distributions to the public". While the closed system introduced more certainty in the area of exempt distributions, it also introduced a level of complexity and lack of flexibility into the regulatory regime. A number of regulations and rules have been adopted to address the inevitable gaps as well as the overreaching impact of the system. In addition, the Commission has had to deal with a proliferation of applications for ad hoc relief from these requirements.

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[15] Subsection 127(1) and Section 127.1.

[16] Section 1.1.

[17] Section 2.1.

5. There have been several recommendations and proposals that have been made in an effort to better assist the capital-raising process. For example, the Final Report of the Task Force on Small Business Financing recommended recasting the current registration and prospectus exemptions.[18] More recently, Commission staff recommended adopting new categories of exemptions in place of the existing ones - see "Revamping the Regulation of the Exempt Market - A Concept Paper prepared by Staff of the Ontario Securities Commission".[19]

II. Focus and Scope of Regulation

8. One example of the shift in the way financial markets are structured arises with respect to the number of exemptions in the Act available to various financial institutions for particular types of securities. However, the elimination of the "four pillars" has enabled issuers that offer substantially similar products to be regulated differently depending on which particular regulator governs the issuer.

9. For example, the Investment Dealers Association (the "IDA") recently launched an arbitration process for disputes which cannot be resolved through regular administrative channels within the investment dealer. The process has been developed for Ontario resident clients of IDA member firms that are registered to under take business in Ontario. The events in dispute must have originated after June 30, 1998 and the claimed amount must exceed $6,000 but cannot exceed $100,000, excluding costs. If the investor decides to utilize this process, the investment dealer is obliged to do so also.

The banking and life insurance sectors in Canada also provide consumer redress mechanisms. Since 1996, the Canadian Banking Ombudsman assisted in resolving complaints from small businesses about bank services. Its mandate was expanded in 1997 to encompass personal banking complaints. In 1998, the Canadian Life and Health Insurance Association introduced an ombudservice to provide informal conciliation for consumers with a complaint about a life insurance company. More recently, the Report of the Task Force on the Future of the Canadian Financial Services Sector (released on September 15, 1998) recommended that a legislated federal financial sector ombudsman should be established for customers of all financial institutions.

Finally, as part of ongoing regulatory reforms in the United Kingdom ("UK") the Financial Services Authority (the "FSA") is required to establish a single, compulsory ombudsman scheme for the speedy and informal resolution of disputes between members of the public and FSA-authorized firms.[20] The financial services ombudsman will replace the existing eight complaint-handling schemes and will be run by a separate company. The company will be legally and operationally independent of the FSA but will be required to report annually to the FSA on the discharge of its functions.

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[18] (1996) 19 OSCB 5753.

[19] (1999) 22 OSCB 2829.

[20] The FSA was created in October, 1997 to replace the Securities and Investments Board and will eventually absorb nine front line regulatory bodies (including the Securities and Futures Authority, the Insurance Directorate of the Department of Trade and Industry and the Personal Investment Authority) and have ultimate authority over all financial services in the U.K. The relevant legislation is the Financial Services and Markets Bill which is expected to receive Royal Assent later this year. Pending Royal Assent, the FSA has been operating under interim arrangements with the existing regulatory bodies. Effective June 1998, the FSA also took over responsibility for the supervision of banks, wholesale money markets and the foreign exchange clearing house, from the Bank of England.

Regulation of Registrants

11. Registration for trading in securities in the capacity of principal or agent, or registration for being engaged in the business of buying, selling, or otherwise advising with respect to securities, will not capture the activity of all market participants who exert influence over decision-making in respect of the purchase of securities. For example, while portfolio managers must be registered as investment counsel/portfolio managers, and have completed stringent proficiency and experience requirements, equity research analysts, whose opinion often contributes to the investment decisions of portfolio managers, need not be registered and need not have complied with any proficiency or experience requirements.

12. In April, 2000 the CSA announced that relief from suitability and know-your-client obligations will be granted on an application basis to dealers who only provide trade execution services for clients. The relief is subject to the dealer complying with certain conditions including that it be an independent entity or unit which does not provide advice or recommendations; that its representatives not be compensated on the basis of transactional values; and that the client first provide written informed acknowledgement that no advice or recommendations will be given.

Self-Regulatory Organizations and Other Market Intermediaries

15. Part VIII of the Act prohibits any stock exchange from carrying on business in Ontario unless recognized by the Commission. However, with respect to SROs other than stock exchanges and with respect to clearing agencies and quotation and trade reporting systems, there is no mandatory recognition requirement. Moreover, the Act does not deal with central depositories and rating agencies. By contrast, in the United States, central depositories and rating agencies are subject to explicit recognition and oversight by the U.S. Securities and Exchange Commission (the "SEC").

17. In 1997 the custody of investments (consisting of safeguarding and administration services) became an "authorisable" activity in the UK. More specifically under the Financial Services Act 1986, it is an offence to carry on custody business in the UK without being an authorised or exempted person. Among the reasons identified by the UK government for making custody an authorisable activity were the considerable risks for investors if the enormous amounts of assets held in custody were not properly controlled.

In particular, the UK government identified the following main hazards: (i) misappropriation through fraud; (ii) delivery otherwise than in accordance with authorised instructions; (iii) the improper use of one customer's investments to settle or secure another's obligations; (iv) failure to maintain adequate records identifying an individual customer's entitlement to, and the status of, investments; (v) unauthorised use of customers' investments for a firm's own purpose or commingling of customers' investments with a firm's investments in such a way as to place customers' investments at risk in the event of the firm's insolvency; and (vi) deficiencies in documentation such that the division of responsibilities in the event of loss as between a customer, an authorised firm and any third parties is unclear. Moreover with the dematerialization of securities there was a growing recognition that the role and responsibilities of custodians were becoming increasingly important yet less clear in law.[21]

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[21] The Securities and Investments Board. Consultative Paper 90. *Custody* (August 1995).

Tiered-Holding System

18. Current Canadian law governing transfers and secured transactions involving securities and other financial products is found in various federal and provincial corporate statutes, federal legislation governing financial institutions, such as the federal Bank Act, Bills of Exchange Act, Depository Bills and Notes Act and provincial personal property security acts.

In the indirect holding system, in the case of registered securities, the beneficial owner is not shown on the issuer's records. In the case of unregistered securities such as bearer bonds, the beneficial owner does not have actual possession of a negotiable certificate. Instead, the securities are registered or in the possession of a securities depository/clearing agency such as the Canadian Depository for Securities. The records of the depository evidence the securities held on behalf of its various participant brokers, banks and trust companies. The records of each participant show the securities held on behalf of their individual customers (typically, the beneficial owners).

In 1994, Article 8 of the U.S. Uniform Commercial Code was revised ("Revised Article 8"). The objective of Revised Article 8 was not to change securities holding practices, but to provide a clear and certain legal foundation for the indirect holding system. The approach was to reform the rules to more accurately describe the special property interest of one who holds a book-entry security position through an intermediary. Revised Article 8 defines a relationship between an intermediary and entitlement holder by establishing a package of rights and obligations called "security entitlements" which is itself a unique form of property interest and not merely a personal claim against an intermediary.[22]

In early 1998, the CSA established a task force whose mandate is to develop a uniform set of Canadian settlement rules and secured lending rules. The intention is for the Canadian rules to be harmonized with Revised Article 8.

Continuous Disclosure Obligations

General

19. In January 1999, the Commission created a Continuous Disclosure Team which is responsible for monitoring and assessing the continuous disclosure record of reporting issuers. The Continuous Disclosure Team intends to review the continuous disclosure record of all reporting issuers in Ontario on a periodic basis through a combination of targeted and random reviews.

In January 2000, the Commission, together with other members of the CSA, published for comment a concept paper relating to the proposed Integrated Disclosure System.[23] The Integrated Disclosure System would integrate the information which reporting issuers are required to provide to investors in both the primary and secondary markets. The goal is to make it simpler for companies to access the market while providing enhanced disclosure for investors. The foundation of the system would be an upgraded "continuous disclosure base" that offers the public information relating to an issuer and its business. The information would be comparable to the information that is currently provided in a prospectus.

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[22] See Eric Spink, Uniform Law Conference of Canada, *Report of the Production Committee*, Tiered Holding System - Uniform Legislation Project (April 30, 1997).

[23] (2000) 23 OSCB 633.

More recently, the Commission published for comment two proposed rules that will upgrade current quarterly reporting requirements. Proposed Rule 52-501, Financial Statements, introduces a new requirement for all public companies to include in interim financial statements an income statement and a cash flow statement for the current quarter in addition to the currently required year to date information.[24] Companies will also be required for the first time to provide an interim balance sheet and explanatory notes to the interim financial statements. A company's board of directors and its audit committee will be required to review the interim financial statements before they are filed with the Commission and distributed to shareholders. The proposed Companion Policy urges Boards, in discharging their responsibilities for ensuring the reliability of interim financial statements, to consider retaining external auditors to conduct a negative assurance review.

Proposed Rule 51-501 reformulates existing OSC Policy 5.10 and introduces a new requirement for management to provide a narrative discussion and analysis (MD&A) of interim financial results with the interim financial statements.[25] This will enable investors to gain an understanding of past corporate performance and future prospects on a more timely basis. The proposed Rule will replace OSC Policy 5.10 and give the Commission greater ability to enforce compliance with annual and interim MD&A content requirements.

On May 29, 1998 the Commission and other members of the CSA published for comment proposed legislative amendments to the Act which would result in the creation of a limited statutory civil liability regime enabling investors that purchase securities in the secondary markets to bring a civil action against issuers and other responsible parties for misrepresentations in disclosure documents and other statements relating to the issuer or its securities (the "Proposal").[26] The Proposal arose out of the CSA's review and support of the Final Report of the Toronto Stock Exchange Committee on Corporate Disclosure (the "Allen Committee") issued in March, 1997.[27] The Allen Committee was established to review continuous disclosure by public companies in Canada and assess the adequacy of such disclosure. The Allen Committee was also asked to consider whether additional remedies ought to be available, either to regulators or to investors, if companies fail to observe the rules.

Materiality

20. CSA National Policy Statement No. 40 ("NP40") and the TSE's Timely Disclosure Policy (the "TSE Policy") are examples of attempts to expand the current concepts of materiality. In November 1997, the Commission published for comment a proposal to amend the definitions of "material fact" and "material change" that would significantly alter the standard of materiality.[28] Under the proposed new standard, facts or changes would be "material" if "substantially likely to be considered important to a reasonable investor in making an investment decision". Neither the Commission nor CSA has pursued these changes.

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[24] (2000) 23 OSCB 1793.

[25] (2000) 23 OSCB 1783.

[26] "Civil Liability for Continuous Disclosure" (1998) 21 OSCB 3367.

[27] The Toronto Stock Exchange Committee on Corporate Disclosure, Final Report, *Responsible Corporate Disclosure - A Search for Balance* (March 1997).

[28] *OSC Request for Comment 51-901: "Material Fact and Material Change"* (1997) OSCB 5751.

The Allen Committee reviewed the distinction between a "material change" and "material information". The Allen Committee concluded that the distinction was "an exercise in sophistry" but had practical implications insofar as issuers are bound by law to disclose "material changes" and not "material information". In its interim report, the Allen Committee concluded that NP40 and the TSE Policy are examples of successful attempts to expand current concepts of materiality.[29] They recommended that material change reporting obligations should be triggered not only when material changes occur but also when material information comes to light. The May 1997 Final Report of the Allen Committee did not refer to these recommendations in the Interim Report.

Financial Disclosure

21. As noted above in commentary 19, the Commission has recently released for comment two rules which will upgrade current quarterly reporting requirements. Under the rules, interim financial statements would be required to include a balance sheet and enhanced note disclosure. Quarterly MD&A would have to be provided; boards of directors, and audit committees where they exist, would be required to review interim financial statements before they are sent to shareholders.

In the United States, concern about corporate audit practices prompted the SEC to appoint a blue-ribbon panel to determine ways to improve the effectiveness of audit committees. The panel's report, released in 1999, outlined a 10-point plan that included a revised definition of what constitutes an independent director, requirement of an independent audit committee for large listed companies, and criteria governing the size, responsibilities, and financial literacy of audit committees. The Financial Accounting Standards Board in the United States has also proposed eliminating the ability of issuers to use "pooling of interests" accounting principles.

In 1999 the International Accounting Standards Committee ("IASC") completed its work in the development of a core set of international accounting standards for international use. Presently, the International Organization of Securities Commissions is undertaking an assessment of the acceptability of these standards. Since the IASC standards are copyrighted, we have not reproduced them as part of this notice. However, summaries of the IASC standards are available from the IASC website at www.iasc.org.uk.

Selective Disclosure

22. Recently, the SEC proposed new rules for comment to address the practice commonly known as "selective disclosure".[30] The SEC's proposed Regulation FD ("Fair Disclosure") provides that if an issuer, or any person acting on its behalf, discloses material non-public information to any other person, the issuer must simultaneously (for intentional disclosures) or promptly (for non-intentional disclosures) make public disclosure of that same information.

The Allen Committee also addressed "equality of access" issues in both its Interim and Final Reports. The Allen Committee made a number of recommendations designed to equalize access of information among investors and prevent selective disclosure of material information. In particular it recognized that the regulatory concern relating to selective disclosure is that "access to better information – let alone to material undisclosed information – represents an inequality of access between retail and institutional investors".

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[29] The Toronto Stock Exchange Committee on Corporate Disclosure, Interim Report, *Toward Improved Disclosure - A Search for Balance in Corporate Disclosure* (December 1995).

[30] Selective Disclosure and Insider Trading, *Release Nos. 33-7787, 34-42259, IC-24209, File No. S7-31-99* (December 20, 1999).

Mutual Funds

24. In her report concerning the investment funds industry (the "Stromberg Report"),[31] Glorianne Stromberg made numerous recommendations relating to the operation and regulation of mutual funds in Canada. One of her recommendations was that investment funds should be required to have an independent board of directors.[32] In its response to the Stromberg Report, the Investments Funds Steering Group agreed with the recommendation, suggesting that each fund family should have a board of at least five members, the majority of whom are independent of the manager and an audit committee comprised entirely of independent members of the board.[33]

Rules in the United States currently require boards of directors for investment funds. Recently the SEC has proposed amending the rules to require that: at least half and up to two-thirds of a fund's directors be independent; and that boards have better access to legal counsel unaffiliated with the fund.

25. The Stromberg Report recommended registration of mutual fund managers.[34] The Investment Funds Steering Group felt that matters relating to the governance of fund managers as corporate entities should be left to applicable existing corporate and securities laws.[35]

Shareholder Communications and Take-over Bids

Proxy Rules

28. The SEC amendments permit communications among shareholders at the following times: before the filing of a registration statement relating to a take-over transaction; before the filing of a proxy statement (regardless of the subject matter or contested nature of the solicitation); and regarding a proposed tender offer without "commencing" the offer and requiring the filing and dissemination of specified information.

In Canada, proponents of this approach argued before the Senate Committee reviewing proposed changes to the Canada Business Corporations Act that continued, informal communication amongst shareholders would foster a higher quality of corporate governance and enable better communication among institutional investors.[36]

Take-over Bids

29. For example, the Commission des valeurs mobilières du Québec has advised in a Notice that it will be asking the CSA Take-Over Bid Committee to consider whether the take-over bid provisions should be extended to transactions which are not structured as take-over bids but which achieve the same result, such as arrangements.[37]

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[31] *Regulatory Strategies for the Mid-'90s - Recommendations for Regulating Investment Funds in Canada* (January 1995).

[32] *Ibid.*, pp. 147 - 154.

[33] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective* (November 1996), p. 50.

[34] Stromberg Report, pp. 87 – 90.

[35] Investment Funds Steering Group, p. 50 fn. 29.

[36] *Report of The Standing Senate Committee on Banking, Trade and Commerce, Corporate Governance* (August 1996).

Enforcement

Insider Trading

30. The use of structured products allows insiders to dispose of economic interests in their securities without disposing of the securities themselves (thereby possibly avoiding insider trading rules). Such products also enable an insider to structure a transaction to deal with his or her holdings without necessarily triggering control block or escrow rules. Should these types of transactions be regulated?

Securities Fraud

31. For example, are additional powers needed to deal with "pump and dump" behaviour?[38]

III. Impact of Regulatory Harmonization and Globalization Trends

32. Recent examples of the trend towards inter-provincial co-operation and harmonization in the administration of securities regulation across Canada include the establishment of the Canadian Securities Regulatory System; the increasingly important role played by the CSA (an informal association representing the Chairs of each of the provincial securities regulators); and the adoption of mutual reliance initiatives. More specifically, the CSA have adopted (or are developing) a mutual reliance review system for filings of prospectuses and AIFs for mutual fund and other issuers; continuous disclosure filings by issuers; applications for discretionary relief; and applications for registration of advisers and members of SROs.[39]

33. For example, as part of its 1992 common market program, the European Community (the "EC") adopted the Investment Services Directive (the "ISD"). Among other things, the ISD grants authorisation to EC investment firms to conduct cross-border operations anywhere in the EC either by physical presence (e.g. branch) or by remote access (i.e., electronic trading) based on a license issued by their respective home states.[40] In return for safeguarding the basic right to branch into or deal across borders with persons in other European member states, investment firms throughout the EC will be subject to certain minimum authorisation requirements and ongoing supervision. Is the European model an appropriate solution for Canada?

V. Mandate and Role of the Commission

39. For example, under the Act, the Commission is required to republish for comment a proposed rule where the Commission proposes "material changes" to the original rule proposal that was published for comment.[41] This requirement has often led to multiple republications of proposed rules and significant time delay. By contrast, SEC proposals are not subject to a second (or subsequent) comment period provided that the final rule is a "logical outgrowth" of the rulemaking proceeding when viewed in light of the original proposal and call for comments.

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[37] Bulletin hebdomadaire 2000-02-11 Vol. XXXI no. 06, pp. 4 - 5.

[38] In the classic "pump and dump" scheme, promoters artificially inflate a stock's price by making false claims about the issuer and by using high-pressure sales tactics to lure investors. After a substantial increase in the share price, the promoters and sometimes the insiders of the issuer take their profits and the stock price plummets.

[39] (1999) 22 OSCB 7293.

[40] Investment services include brokerage, dealing as principal, market making, portfolio management, underwriting, investment advice, safe keeping and administration.

40. Many securities regulators in Canada and globally have the power to levy monetary penalties. Should the Commission have such an enforcement power? Moreover, should the number of public interest orders that the Commission can make be expanded to include some of the orders that a court can make under section 128(3) of the Act? For example, should the Commission have the power to make a compliance order as set out under subsection 128(3)1? Similarly, should the Commission have the power to order that a registrant repay to its clients all or any part of the money paid by the client for securities purchased through the registrant where the registrant has behaved inappropriately in that context?

41. The mandate of the Commission is to: (a) provide protection to investors from unfair, improper or fraudulent purposes; and (b) foster fair and efficient capital markets and confidence in capital markets. In the UK, under the Financial Services and Markets Bill, the statutory objectives of the FSA are to: (i) maintain market confidence; (ii) promote public awareness; (iii) protect consumers; and (iv) reduce financial crime.

42. It is useful to note guiding principles that have been proposed or enacted with respect to other administrative bodies. In the UK under the Financial Services and Markets Bill, the FSA in pursuing its statutory objectives must have regard to (i) the need to use its resources in the most efficient and economic way; (ii) the responsibilities of those who manage the affairs of authorized persons; (iii) the principle that restrictions imposed on firms and markets should be in proportion to the expected benefits for consumers and the industry; (iv) the desirability of facilitating innovation in connection with regulated activities; (v) the international character of financial services and markets and the desirability of maintaining the competitive position of the UK; (vi) the need to minimize the adverse effects on competition that may arise from any exercise of its general functions; and (vii) the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

The Australian Securities and Investments Commission ("ASIC") enforces and administers Corporations Law and consumer protection law for investments, life and general insurance, superannuation and banking (except lending) throughout Australia. The ASIC has the function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system, the provision of financial services, and the payment system. In performing its functions and exercising its powers, the ASIC must strive to: (i) maintain, facilitate, and improve, the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; (ii) promote the confident and informed participation of investors and consumers in the financial system; (iii) achieve uniformity throughout Australia in how the Commission and its delegates perform those functions and exercise those powers; (iv) administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements; (v) receive, process, and store, efficiently and quickly, the information given to the Commission under the laws that confer functions and powers on it; (vi) ensure that information is available as soon as practicable for access to the public; and (vii) take whatever action it can take, and is necessary, in order to enforce and give effect to the laws that confer functions and powers on it.[42]

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[41] Subsection 143.2(7).

[42] *Australian Securities and Investments Commission Act, 1989*, subsection 1(2).

APPENDIX 1 [to Issues List]

Advisory Committee Appointed to Review Securities Law

Ministry of Finance News Release - TORONTO, March 2 /CNW/ - Finance Minister Ernie Eves announced he has established an Advisory Committee to review the province's securities legislation. The Committee's mandate is to ensure the legislation is up-to-date and enables the Ontario Securities Commission to aggressively and proactively enforce clear standards to protect investors and foster a fair and efficient marketplace.

"Securities regulation that is firm, fair and effective instills investor confidence which is fundamental to economic growth and job creation," Eves said.

The committee will be chaired by Purdy Crawford Q.C., counsel to Osler, Hoskin & Harcourt, former chairman of Imasco and chairman of AT&T Canada. Other committee members are Carol Hansell, a partner with Davies, Ward & Beck; William Riedl, president and CEO of Fairvest Securities Corporation; Helen Sinclair, CEO of BankWorks Trading Inc; David Wilson co-chairman and co-CEO at Scotia Capital; and Susan Wolburgh Jenah, OSC general counsel.

Minister Eves extended his personal thanks to each of the committee members for agreeing to participate. "This is a group of highly qualified individuals who will bring to the table a depth of knowledge and diversity of perspectives," Eves said.

As a result of the Securities Amendment Act, 1994, the government is required to review the legislation, regulations and rules relating to matters dealt with by the Ontario Securities Commission every five years.

Purdy Crawford Q.C., is counsel to the law firm of Osler, Hoskin & Harcourt, former chairman of Imasco and chairman of AT&T Canada. A Harvard Law graduate, and member of the Ontario Bar, Mr. Crawford has received a number of honours including Officer of the Order of Canada and Honorary Doctorates of Laws from Mount Allison University and Dalhousie University. Mr. Crawford is chancellor of Mount Allison University and a director of a number of public companies in Canada and the United States. Mr. Crawford has agreed to chair the Advisory Committee.

Carol Hansell, is a partner with the law firm Davies, Ward & Beck specializing in corporate finance and securities, as well as mergers and acquisitions. Ms. Hansell has written a number of papers, articles and commentaries on a variety of corporate governance topics and is the author of Directors and Officers in Canada: Law and Practice.

William Riedl is the president and CEO of Fairvest Securities Corporation, an institutional stock brokerage firm specializing in matters of corporate governance and shareholder rights. He is also a director of the Investment Dealers Association of Canada.

Helen Sinclair is CEO of BankWorks Trading Inc. She was president of the Canadian Bankers Association from 1989 to 1996, and prior to that senior vice president and general manager, planning and legislation for Bank of Nova Scotia. Ms. Sinclair is a governor of York University, past chair of the YMCA of Greater Toronto, and a director of a number of public companies including TD Bank and Stelco.

David Wilson is the co-chairman and co-CEO at Scotia Capital and has an extensive background in corporate finance. Mr. Wilson is a past chairman of the Investment Dealers Association of Canada, and a director of a number of companies, including Rogers Communications Inc.

Susan Wolburgh Jenah is the general counsel for the Ontario Securities Commission, responsible for providing general legal and policy advice and project management support to both the Commission and staff. Ms. Jenah joined the Commission in August 1983 and has held various positions.

Appendix C: List of Commenters

1. Ms. Sheila Noyes
2. John Palmer,
   Superintendent of Financial Institutions Canada
3. Smith Lyons
4. James C. Baillie
5. Dina Palozzi,
   Chief Executive Officer and Superintendent of Financial Services
   Financial Services Commission of Ontario
6. Mr. Larry Schwartz, by email (requesting confidentiality)
7. Investment Counsel Association of Canada
8. The Investment Funds Institute of Canada
9. PricewaterhouseCoopers
10. Canadian Securities Institute
11. KPMG LLP
12. British Columbia Securities Commission
13. The Canadian Depository for Securities Limited
14. Glorianne Stromberg
15. Investment Dealers Association of Canada
16. Canadian Institute of Chartered Accountants
17. Canadian Association of Insurance and Financial Advisors
18. Torys
19. Canadian Bankers Association
20. Ontario Teachers' Pension Plan Board
21. Alberta Securities Commission

22. Canadian Investor Relations Institute

23. Canadian Venture Exchange

24. Simon Romano, Stikeman Elliott (Personal Comments)

25. Osler, Hoskin & Harcourt LLP

26. CBAO Securities Law Subcommittee

27. Nancy Ross

28. Montreal Exchange

29. Aur Resources Inc.

30. Take-Over Bid Team at the Ontario Securities Commission

31. Small Investor Protection Association

32. Torys – James E. A. Turner

* *Copies of letters submitted by the commenters can be found at* www.osc.gov.on.ca.

Appendix D - Presenters to Committee

1. Canadian Institute of Chartered Accountants

2. Michael Lauber, Canadian Banking Ombudsman

3. Joe Oliver, Executive Director
   Keith Rose, Vice-President, Regulatory Policy
   Investment Dealers Association of Canada

4. Phil Anisman

5. IFIC

Appendix E: Ontario Securities Commission Staff Presentations to Committee

1. Randee Pavalow
   Tracey Stern
   Re: Alternative Trading Systems

2. Stan Magidson
   Janet Holmes
   Terry Moore
   Naizam Kanji
   Re: Take-over bids

3. Michael Watson
   Johanna Superina
   Hugh Corbett
   Greg Ljubic
   Re: Enforcement

4. Max Pare
   Re: Tiered Holdings Project

5. Julia Dublin
   Randall Powley
   Re: Re-Regulation of Advice Project

6. John Carchrae
   Re: Accounting Matters

7. Christopher Byers
   Re: Globalization

Appendix F: Lessons from Australia

In trying to address the feasibility of creating a national securities regime in Canada we considered the historical development of Australia's current system of securities regulation.

By way of background, the Australian constitution, as in Canada, provides for the division of powers between the States and the federal Commonwealth Government. Section 51(xx) of the Australian constitution gives the Commonwealth Government the power to legislate with respect to "foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth". Each State and Territory, on the other hand, has power under its own constitution to make laws for the "peace, order and good government" of that State and Territory.

Prior to 1970, corporate law (and securities regulation) in Australia was administered by individual States and Territories. In 1961 in response to frustrations expressed by market participants regarding the problems of doing business with six different legislative regimes and recognizing the existence of the national character of the Australian economy, the States and Territories passed uniform corporate legislation, similar to the United States Commercial Code. In time, however, differences among the States' and Territories' enactments emerged due to amendments of the legislation on a state by state basis.[1]

In 1970, in the wake of several financial scandals, a select senate committee was formed to consider the Australian securities industry. The Rae Committee, as it came to be known, released a report in 1974 which detailed findings of numerous unfair practices and criticized the various State and Territorial legislators for their inadequate performance in regulating the securities markets.[2] The committee recommended that a Commission similar to the United States Securities and Exchange Commission be established to oversee and regulate the securities market since the national character of the securities industry in Australia made State regulation inappropriate.[3]

In 1978, as an alternative to direct Commonwealth legislation, the Australian Commonwealth entered into an inter-governmental agreement with the States and Territories to create a cooperative scheme for regulating securities markets in Australia. The new scheme consisted of three administrative tiers. At the top was a Ministerial Council, a body consisting of one minister from each state and territorial government as well as one Commonwealth minister. Directly below was a newly created body, the National Companies and Securities Commission ("NCSC"), designed as the central administrator of the scheme. Finally, each State and Territory maintained a Corporate Affairs Commission ("CAC") to perform the bulk of administrative duties under the scheme. Under the scheme, the Commonwealth passed companies and securities legislation for Australia's federal jurisdiction, and each state and territory, through local legislation, applied the federal legislation by reference.[4]

While the cooperative scheme was successful in establishing uniform companies regulation throughout Australia, it was plagued by problems and was unable to adequately fill the void in Australia's company and securities legislation. In particular, the cooperative scheme suffered from a lack of uniform administration by the State Corporate Affairs Commissions; lack of accountability, and duplication of functions between the State Corporate Affairs Commissions and the National Companies and Securities Commission.[5] Moreover, there were general concerns about the need for more effective national enforcement. In particular, under the scheme the NCSC could not initiate prosecutions or interfere in enforcement at the state or territorial level. Finally, Australia's securities exchange industry was consolidating, culminating in April 1987 with the establishment of one national stock exchange.

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[1] Paul von Nessen, *The Americanization of Australian Corporate Law*, 26 Syracuse Journal of International Law and Commerce 239.

[2] Jeffery Lehman, *The Bre-X Stock Debacle: Why the Enactment of Canadian Federal Securities Legislation Would be Good as Gold*, 24 Brooklyn Journal of International Law 823.

[3] Alan Shaw and Paul von Nessen, *The Legal Role of the Australian Securities Commission and The Australian Stock Exchange*.

[4] *Supra.*, note 1.

Growing dissatisfaction with the ineffectiveness of the NCSC to properly enforce corporate law led to an inquiry by a select senate committee. In a report released in May 1987, the senate committee, acknowledging the problems with the cooperative scheme, concluded that the cooperative scheme should be replaced by comprehensive national legislation and that a single agency charged with administering such legislation should be established. In May 1988 in response to the criticisms of the cooperative scheme, the Australian Commonwealth government asserted power to enact legislation covering the entire legislative field relating to corporations and securities. The federal legislation established the Australian Securities Commission (the "ASC") as the sole administrative authority of corporate and securities law throughout Australia. State and territorial corporate authorities were to have no further authority in areas of regulation delegated to the ASC, although the ASC was required to establish a regional office in each Australian state and territory.

In time, certain aspects of the federal legislation were challenged by several states and were subsequently held to be invalid by Australia's High Court.[6] The High Court's decision meant that comprehensive nation wide companies and securities legislation was impossible without co-operation between the Commonwealth, the States and Territories. Accordingly in 1990, the Commonwealth, States and Territories entered into an agreement under which national legislation was enacted to deal with the entire field relying on combined Commonwealth and State and Territorial powers. Under the agreement:

1. ASC (now the Australian Securities and Investments Commission) was established as the national regulator to assume full responsibility for the regulation of companies. ASC replaced the State CAC and the NCSC. ASC was responsible and accountable to the relevant Commonwealth Minister and the Commonwealth Parliament.

2. The Commonwealth would amend its federal legislation so that it would apply in the Australian Capital Territory. Each State and Territory would then apply such federal law as a law of its jurisdiction.

3. Each state and territory was to legislate so as to require courts and others to treat the applied law as if it were a law of the Commonwealth. For example, the Federal Court was given power to hear matters arising under the State statutes and the investigation and prosecution of offences under the various State statutes would be undertaken by ASC and federal prosecutors.

4. The Ministerial Council was to continue but under new arrangements giving the Commonwealth more ower, the Commonwealth Attorney-General becoming the permanent chair. The Council would have no control over the ASC.

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[5] Ian Ramsay. *The Unravelling of Australia's Federal Corporate Law* (https://cclsr.law.unimelb.edu.au/Bulletins/ Bulletin0031.htm).

[6] See *New South Wales v. Commonwealth* (1990) 169 CLR 482, where the Australian high court held that the constitution did not confer on the Commonwealth Government power to deal with the incorporation of companies. Only the state and territorial governments have this power.

5. Proposals for new legislation were to be considered by the Council. The Commonwealth when introducing them into Commonwealth Parliament was to table the Council's advice. However, legislative reform on national markets (take-overs, securities, public fundraising and futures) was to be the sole responsibility of the Commonwealth. Other proposals were to be approved by the Council before introduction into the Commonwealth Parliament. But the Commonwealth was not obliged to introduce any proposal of which it did not approve. On such matters the Commonwealth was to have four votes, each state and territory having one vote. The Commonwealth was given a casting vote.

Any amendments that the Commonwealth Government made to its statute would automatically apply in each of the States and Territories without the need for the State and Territorial Parliaments to pass further amendments.